

**STRENGTHENING SOCIAL SECURITY:
WHAT CAN PERSONAL RETIREMENT ACCOUNTS
DO FOR LOW-INCOME WORKERS?**

HEARING
BEFORE THE
SPECIAL COMMITTEE ON AGING
UNITED STATES SENATE
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STRENGTHENING SOCIAL SECURITY: WHAT CAN PERSONAL RETIREMENT ACCOUNTS DO FOR LOW-INCOME WORKERS?

TUESDAY, JUNE 15, 2004

U.S. SENATE,
SPECIAL COMMITTEE ON AGING,
Washington, DC.

The committee met, pursuant to notice, at 10:32 a.m., in room SD-628, Dirksen Senate Office Building, Hon. Larry E. Craig (chairman of the committee) presiding.

Present: Senators Craig and Kohl.

STATEMENT OF SENATOR LARRY CRAIG, CHAIRMAN

The CHAIRMAN. Good morning, everyone. The U.S. Senate Special Committee on Aging will convene.

Thank you all very much for being with us this morning and allowing us to adjust schedules a little bit for the joint session earlier this morning.

Last year, my good friend and Ranking Member of the Committee John Breaux and I asked the GAO to use its analytical expertise to evaluate how the Social Security status quo or do-nothing plan would redistribute benefits for workers. We also asked how well personal retirement account models and other proposals might affect redistribution of Social Security benefits for our children and grandchildren. I was especially interested in this report as on objective and nonpartisan analysis. It is important for us to understand how reform would impact those in most need, the low-income workers.

Today's GAO on study on Social Security redistribution builds on previous reports requested by myself and Senator Breaux and represented before this Committee by the Comptroller General. This Committee has been very active on issues of income security in retirement. The GAO continues to strongly support the research interests of this Committee, and we thank you, Mr. Walker, and all of your staff for the high of the quality of the work products that you present.

As the United States considers personal retirement accounts as one potential option for strengthening Social Security, it is important that we understand how different proposals impact low-, middle-, and high-income workers. I want to emphasize that the topic of this hearing is really about America's youth. Those currently on Social Security and about to retire will not be affected by any reforms discussed here today.

Finally, I would also like to comment on the Congressional Budget Office study released yesterday with different projections on the issue of solvency compared to Social Security's Office of Actuary. Those who advocate we do nothing suggests the CBO supports their position because insolvency is pushed forward by another decade. On the contrary, the problem of insolvency is still there, though we have a little more breathing room on the front, but the cash-flow deficit is still projected to occur prior to 2020.

As many of us know, insolvency isn't the only reason reform is necessary. We must also be concerned about long-run sustainability of the system and adequacy of benefits and a fair return for middle- and high-income workers. It appears the CBO projects that many low- and middle-income retirees will receive lower benefits than the actuaries were projects. As a result and contrary to the do-nothing crowd's response to the CBO study, today's hearing on benefits levels takes on an even greater importance in light of the CBO's findings.

With that, I am pleased to welcome our distinguished witnesses to the Aging Committee. On panel one, we have a single witness, one who is very familiar to this committee, David Walker, the Comptroller General of the General Accounting Office.

On our second panel, we will hear from Peter Ferrara of the Institute for Policy Innovation and the Club for Growth; Dr. Jeff Brown, professor of Finance for the University of Illinois at Urbana Champaign Campus; Jeff Lemieux, executive director for the Centrist.Org of Washington DC., a think tank; along with Dr. Christian Weller, a senior economist mist from the Center for American Progress here in Washington.

So I look forward to all of their testimony, and, David, let us begin this morning with you, and again, thank you for allowing us to be a little flexible in our schedule.

**STATEMENT OF HON. DAVID M. WALKER, COMPTROLLER
GENERAL, GENERAL ACCOUNTING OFFICE, WASHINGTON, DC**

Mr. WALKER. Thank you, Mr. Chairman. I also appreciate your understanding in recognizing that I need to try to get out of here by eleven because I have a hearing on the House side.

The CHAIRMAN. We will keep you on schedule.

Mr. WALKER. Thank you, Mr. Chairman.

I appreciate you inviting me here today to continue our dialog on a range of issues of mutual interests concerning the Social Security system and potential reform proposals. As I have stated before on numerous occasions, without substantive reforms, both of Social Security and the Medicare programs are unsustainable in their present form, and their long term impact on the Federal budget and the economy will be dramatic.

Today, we are issuing a report at your request and the Ranking Minority Member, dealing with the issue of distribution of benefits and taxes relative to earnings levels. We believe this is an important contribution to the continuing discussion and debate about various Social Security reform proposals, and before I summarize the results of that report, I think it is important to make a few overview comments.

First, Social Security reform is a part of a broader fiscal and economic challenge. In fact, it is a subset of a major fiscal imbalance that we face. The biggest part of it is Medicare. Second, focusing on trust fund solvency alone, as you noted in your opening comments, is not sufficient. We need to put the program on a path toward sustainable solvency and to consider cash-flow, to consider its percentage of the federal budget, its percentage of the economy, etc. Third, solving Social Security's long-term financing problem is more than important and complex and simply making the numbers add up. It is not just about sustainable solvency. It also involves adequacy, equity, and administrative feasibility considerations. Last, but certainly not least, acting sooner rather than later would help to ease the transition difficulty and help facilitate the need for us to move on to much more difficult complex and controversial reforms, namely health care reform in general, and Medicare, in particular.

As you know, Mr. Chairman, under Social Security, retired workers can receive benefits at age 65 that equal about 50 percent of their pre-retirement earnings for an illustrative worker with relatively low earnings, but only about 30 percent for individuals with relatively higher earnings. To ensure that beneficiaries have adequate incomes, Social Security's current benefit formula is designed to be progressive, that is to provide disproportionately larger Social Security benefits as a percentage of pre-retirement earnings to lower earners than to higher earners.

However, the benefit formula is just one of several program features that influence the way benefits are distributed. One such program feature includes provisions for disabled workers, spouses, children, and survivors. Changes in the program over time will affect the distribution of benefits across generations. So the distribution of Social Security benefits can vary by eligibility, household type, and birth year, as well as by earnings level.

As you know, over the last several years, we have been developing increased capacity to use micro-simulation models and other types of tools to help quantify the effects of possible Social Security reform proposals, and in doing that, I would like to move on to the requested study. There are two distinct perspectives, in our view, relating to Social Security's goals that suggest different approaches to measuring progressivity. Both perspectives provide valuable insights, in our opinion. First, an adequacy perspective focuses on benefit levels and how well they help to ensure a minimal subsistence or maintain pre-retirement-level living standards. Second, an equity perspective focuses on rates of return and other measures relating to lifetime benefits and relative individual contributions. This perspective also gauges whether the system gives people a, quote-unquote, fair deal for their contributions. These measures themselves describe the adequacy and equity, but the distribution with respect to earnings level describes progressivity.

It is important to note that equity measures cannot accurately assess the distributional effects of reform proposals that rely upon general revenue transfers, because they don't specify who is going to end up paying for those general revenue transfers, namely what the relative tax burden is going to be with regard to those general revenue transfers. In our view, estimating future effects on Social

Security benefits should reflect the fact that the program faces a long-term actuarial deficit and benefit reductions and/or revenue increases will be necessary in order to restore program solvency.

Social Security's current distributional effects reflect program features and demographic patterns among its various recipients. The retired worker benefit formula favors low earners by design. In addition, the disability benefit formula also favors low earners since disability recipients are disproportionately low earners. Alternatively, individual Social Security reform proposals would have different distributional effects, reflecting various provisions that make up the proposed reform proposal.

In particular, for example, Model 2 of the President's Commission to Strengthen Social Security proposes a new system of voluntary individual accounts along with a combination of certain benefit reductions for all beneficiaries and selected benefit enhancements for selected low earners and survivors. One of its provisions would reduce Social Security defined benefits proportionately for all workers by modifying the current benefit formula. At the same point in time, benefits would be enhanced for certain lower earners and surviving spouses, and 4 percentage points of an individual's payroll taxes up to a thousand dollar annual limit could be diverted an individual investment accounts.

To illustrate the distributional effects of this proposal, we used our micro-simulation model to estimate the benefits under it and under our various benchmark scenarios. We did not examine the distributional effect of the equity measures because it presumes significant general revenue transfers and it is difficult to ascertain who will bear the burden of those general revenue transfers. Since the account participation is voluntary—by that, I mean the individual account participation—we use two simulations to show the bounds, one simulation that assumed that there is one hundred percent participation in individual accounts and another one that assumed there would be zero. From a practical standpoint, we know it is going to be somewhat in between.

We also assumed that account participants would have the same asset allocation, that they would invest in the same type of portfolios, if have you will, divided between equities, fixed income, investments etc.

Based on our simulations, the distribution effects under Model 2 of the President's Commission could favor lower earners more than the distribution of benefits under either the currently promised or currently funded benefits/services. Stated differently, the distribution of benefits or the progressivity under Model 2 would be better than under the current Social Security program. It is important, however, to note that while the simulation suggests that the distribution of benefits under Model 2 is more progressive than the benchmarks under the current program, that does not mean that benefit levels are always higher.

Progressivity is about how the pie is divided up. It is not about how big the pie is, and, therefore, something can be more progressive, but the benefit may not be more adequate. According to our simulation, median household lifetime benefits for the bottom fifth of the population under Model 2-0, would be 3 percent higher than under the funded benefits scenario, but 21 percent lower than

under the promised benefits scenario. Medium household lifetime benefits for the bottom fifth under Model 2–100 percent would be 26 percent higher than under the funded benefits scenario, but 4 percent lower than under the promised benefits scenario.

I think it is important, last, to note that we used individuals born in 1985 as a basis to do our simulation because you were concerned about the longer-term effects on our children and grandchildren, appropriately so. Importantly, the results could differ depending upon the age of the individual and nature of the reform proposals going forward.

So in conclusion, Mr. Chairman, we are happy to provide this study. We believe it represents an additional contribution to the very important ongoing discussion and debate about the need for Social Security reform. My personal opinion, having been a former trustee of Social Security and Medicare, having consulted in the private sector for many years in the pension and health areas, is that we have an opportunity to reform Social Security in a way that will exceed the expectations of every generation of Americans if we put our mind to it. The sooner we act, the better. We look forward to working with this Committee and other interested parties in the Congress to try to achieve this desirable outcome.

Thank you, Mr. Chairman.

[The prepared statement of Mr. Walker follows:]

GAO

United States General Accounting Office

Testimony
Before the Special Committee on Aging,
U.S. Senate

For Release on Delivery
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Tuesday, June 15, 2004

SOCIAL SECURITY

Reform Proposals Could Have a Variety of Effects on Distribution of Benefits and Payroll Taxes

Statement of David M. Walker
Comptroller General of the United States



GAO-04-872T

GAO
Accountability Integrity Reliability
Highlights

Highlights of GAO-04-872T, a testimony for the Special Committee on Aging, United States Senate

Why GAO Did This Study

Under the current Social Security benefit formula, retired workers can receive benefits at age 65 that equal about 50 percent of pre-retirement earnings for an illustrative low-wage worker but only about 30 percent for an illustrative high-wage worker. Factors other than earnings also influence the distribution of benefits, including the program's provisions for disabled workers, spouses, children, and survivors. Changes in the program over time also affect the distribution of benefits across generations.

Social Security faces a long-term structural financing shortfall. Program changes to address that shortfall could alter the way Social Security's benefits and revenues are distributed across the population and affect the income security of millions of Americans.

The Chairman of the Senate Special Committee on Aging asked us to discuss how selected Social Security reform proposals might affect the distribution of benefits and taxes.

www.gao.gov/cgi-bin/getrpt?GAO-04-872T.

To view the full product, including the scope and methodology, click on the link above. For more information, contact Barbara Bovbjerg at (202) 512-7215 or bovjberg@gao.gov.

June 15, 2004

SOCIAL SECURITY

Reform Proposals Could Have a Variety of Effects on Distribution of Benefits and Payroll Taxes

What GAO Found

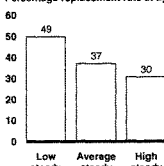
Two distinct perspectives on Social Security's goals suggest different approaches to measuring "progressivity," or the distribution of benefits and taxes with respect to various earnings levels. Both perspectives provide valuable insights. An adequacy perspective focuses on benefit levels and how well they maintain pre-retirement living standards. An equity perspective focuses on rates of return and other measures relating lifetime benefits to contributions. Both perspectives examine how their measures are distributed across earnings levels. However, equity measures take all benefits and taxes into account, which is difficult to calculate for reform proposals that rely on general revenue transfers because it is unclear who will bear the relative burden for those general revenues.

The Social Security program's distributional effects reflect both program features and demographic patterns among its recipients. In addition to the benefit formula, disability benefits favor lower earners because disabled workers are more likely to be lower lifetime earners. In contrast, certain household patterns reduce the system's tilt toward lower earners, for example, when lower earners have high-earner spouses. The advantage for lower earners is also diminished by the fact that they may not live as long as higher earners and therefore would get benefits for fewer years on average.

Proposals to alter the Social Security program would have different distributional effects, depending on their design. Model 2 of the President's Commission to Strengthen Social Security proposes new individual accounts, certain benefit reductions for all beneficiaries, and certain benefit enhancements for selected low earners and survivors. According to our simulations, the combined effect could result in lower earners receiving a greater relative share of all benefits than under the current system if all workers invest in the same portfolio.

Social Security Benefit Formula Provides Higher Replacement Rates for Lower Earners

Percentage replacement rate at age 65



Source: GAO analysis using SSA AMFRIA program.

Notes: Replacement rates are the annual retired worker benefits at age 65 for workers born in 1985 divided by the earnings in the previous year. For such workers, the full retirement age will be 67. Steady earners have earnings equal to various percentages of Social Security's Average Wage Index in every year of their careers.

United States General Accounting Office

Mr. Chairman and Members of the Committee:

Thank you for inviting me here today to discuss the potential effects of selected Social Security reform proposals.¹ Social Security not only represents the foundation of our retirement income system; it also provides millions of Americans with disability insurance and survivor's benefits. As a result, Social Security provides benefits that are critical to the current and future well-being of virtually all Americans. However, as I have said in congressional testimonies over the past several years,² the system faces both solvency and sustainability challenges in the longer term. The challenges of combating terrorism have come to the fore as urgent claims on the federal budget. At the same time, Social Security's long-term pressures on the budget have not diminished. Indeed, our long-range challenges are greater than ever. Without substantive reforms, Social Security and Medicare are unsustainable, and their long-term impact on the federal budget and the economy will be dramatic.

Social Security faces a long-term structural financing shortfall largely because people are living longer and having fewer children. According to the 2004 intermediate—or best-estimate—assumptions of the Social Security trustees, Social Security's annual benefit payments will exceed annual cash revenues beginning in 2018, and it will be necessary to draw on trust fund reserves to pay full benefits. To do this, the Treasury will need to obtain cash for those redeemed securities either through increased taxes and/or spending cuts and/or more borrowing from the public. In 2042, the trust funds will be exhausted, and annual revenues will only be sufficient to pay about 73 percent of benefits. As a result, some combination of benefit and/or revenue changes will be needed to restore the long-term solvency and sustainability of the program.

Last July, I testified before this committee on the need for early action to reform Social Security and specifically how failing to do so would place a burden on younger generations, lower earners, and the disabled. In point of fact, any reform proposal will have implications for how benefits and related taxes are distributed across the entire population. Today, we are issuing a report you requested to examine such distributional effects, specifically those effects relative to various earnings levels. I hope my

¹Social Security refers here to the Old-Age, Survivors, and Disability Insurance (OASDI) program.

²See the list of related GAO products at the end of this statement.

testimony today will help illustrate the potential distributional effects of Social Security reforms and will place such effects in a broader context.

Before I summarize the findings from this analysis, let me first highlight a number of important points in connection with our Social Security challenge.

- **Social Security reform is part of a broader fiscal and economic challenge.** If you look ahead in the federal budget, the combined Social Security program (Old-Age and Survivors Insurance and Disability Insurance), together with the rapidly growing health programs (Medicare and Medicaid), will dominate the federal government's future fiscal outlook. Absent reform, the nation will ultimately have to choose between persistent, escalating federal deficits and debt, huge tax increases and/or dramatic budget cuts.
- **Focusing on trust fund solvency alone is not sufficient. We need to put the program on a path toward sustainable solvency.** Trust fund solvency is an important concept, but focusing on trust fund solvency alone can lead to a false sense of security about the overall condition of the Social Security program. The size of the trust fund does not tell us whether the program is sustainable—that is, whether the government will have the capacity to pay future claims or what else will have to be squeezed to pay those claims. Aiming for sustainable solvency would increase the chance that future policy makers would not have to face these difficult questions on a recurring basis. Estimates of what it would take to achieve 75-year trust fund solvency understate the extent of the problem because the program's financial imbalance gets worse in the 76th and each subsequent year.³
- **Solving Social Security's long-term financing problem is more important and complex than simply making the numbers add up.** Social Security is an important and successful social program that affects virtually every American family. It currently pays benefits to more than 46 million people, including retired workers, disabled workers, the spouses and children of retired and disabled workers, and the survivors of deceased workers. The number of individuals receiving benefits is expected to grow to over 68 million by 2020. The program has been highly

³In addition to assessing a proposal's likely effect on Social Security's actuarial balance, a standard of sustainable solvency involves looking at (1) the balance between program income and cost beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

effective at reducing the incidence of poverty among the elderly, and the disability and survivor benefits have been critical to the financial well being of millions of others.

- **Acting sooner rather than later would help to ease the difficulty of change.** As I noted previously, the challenge of facing the imminent and daunting budget pressure from Medicare, Medicaid, and OASDI increases over time. Social Security will begin to constrain the budget long before the trust funds are exhausted in 2042. The program's annual cash flow is projected to be negative beginning in 2018. Social Security's annual cash deficit will place increasing pressure on the rest of the budget to raise the resources necessary to meet the program's costs. Waiting until Social Security faces an immediate solvency crisis will limit the scope of feasible solutions and could reduce the options to only those choices that are the most difficult. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning while helping to avoid related "expectation gaps." It would also help to ensure that the "miracle of compounding" works for us rather than against us. Finally, acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs.

To assist the Congress in its deliberations, GAO has developed criteria for evaluating various Social Security reform proposals. These criteria aim to balance financial and economic considerations with benefit adequacy and equity issues and the administrative challenges associated with various proposals. The use of these criteria can help facilitate fair consideration and informed debate about Social Security reform proposals.

To help ensure adequate incomes, Social Security's benefit provisions are designed to favor lower earners, disabled workers, and workers with dependents. Changes in the program over time also affect the distribution of benefits and taxes across generations. So, Social Security's distributional effects can vary by eligibility, household type, and birth year, as well as by earnings level. Our focus today is the distribution of benefits and taxes relative to various earnings levels, or "progressivity." Two distinct perspectives on Social Security's goals suggest different approaches to measuring progressivity, and both provide valuable insights. One perspective focuses on measures of the adequacy of benefits while the other focuses on "equity" measures, such as internal rates of return. The measures themselves describe either adequacy or equity, but their distribution with respect to earnings level describes progressivity.

However, when proposals use general revenue transfers, estimating equity measures becomes difficult because such proposals do not generally specify what kind of future taxes or spending cuts will finance the transfers or who will bear the related burden.

The Social Security program's distributional effects reflect both program features and demographic patterns among its recipients. While the benefit formula and disability provisions favor lower earners, household and mortality patterns serve to reduce the system's tilt toward lower earners.

Alternative Social Security reform proposals would have different distributional effects, reflecting the variety of provisions in them. The various provisions include different ways, within the current program structure, of reducing certain benefits, enhancing selected benefits, and enhancing revenues. Certain reform provisions also include creating a new system of individual retirement savings accounts with different account contribution levels and different ways of adjusting Social Security defined benefits to reflect the diversion of Social Security contributions into the accounts. Individually and in combination, these provisions would affect the distribution of benefits and taxes relative to various earnings levels.

Social Security's Long-Term Financing Problem Deserves Timely Action

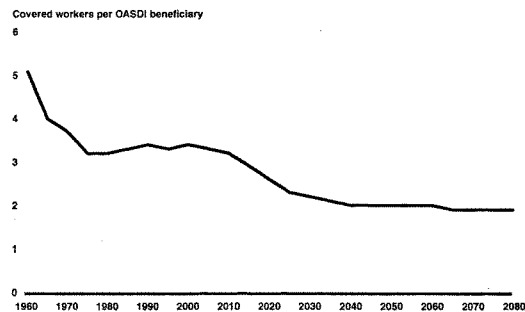
Today the Social Security program faces a long-range and fundamental financing problem driven largely by known demographic trends. The lack of an immediate solvency crisis affects the nature of the challenge, but it does not eliminate the need for action. Acting soon reduces the likelihood that the Congress will have to choose between imposing severe benefit cuts and unfairly burdening future generations with the program's rising costs. Acting soon would allow changes to be phased in so the individuals who are most likely to be affected, namely younger and future workers, will have time to adjust their retirement planning. Since there is a great deal of confusion about Social Security's current financing arrangements and the nature of its long-term financing problem, I would like to spend some time describing the nature, timing, and extent of the financing problem.

Demographic Trends Drive Social Security's Long- Term Financing Problem

As you all know, Social Security has always been largely a pay-as-you-go system. This means that current workers' taxes generally pay current retirees' benefits. As a result, the relative number of workers and beneficiaries has a major impact on the program's financial condition. This ratio, however, is changing. In 1950, before the Social Security system was mature, the ratio was 16.5:1. In the 1960s, the ratio averaged 4.2:1. Today it

is 3.3:1, and it is expected to drop to around 2.2:1 by 2030. The retirement of the baby boom generation is not the only demographic challenge facing the system. People are retiring early and living longer. A falling fertility rate is the other principal factor underlying the growth in the elderly's share of the population. In the 1960s, the fertility rate was an average of 3 children per woman. Today it is a little over 2, and by 2030 it is expected to fall to 1.95—a rate that is below the level necessary to replace the population. Taken together, these trends serve to threaten the financial solvency and sustainability of this important program. (See fig. 1.)

Figure 1: Social Security Workers per Beneficiary

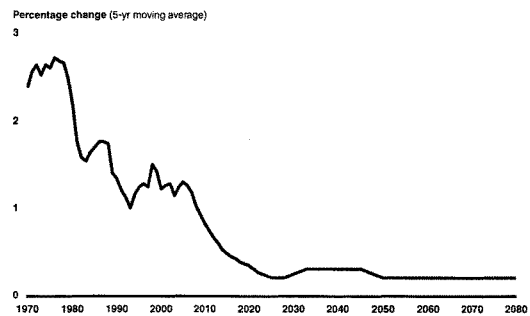


Source: Office of the Chief Actuary, Social Security Administration.

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' reports.

The combination of these trends means that annual labor force growth will begin to slow after 2010 and by 2025 is expected to be less than a third of what it is today. (See fig. 2.) Relatively fewer workers will be available to produce the goods and services that all will consume. Without a major increase in productivity, low labor force growth will lead to slower growth in the economy and to slower growth of federal revenues. This in turn will only accentuate the overall pressure on the federal budget.

Figure 2: Labor Force Growth Is Expected to be Negligible by 2050



Source: GAO analysis of data from the Office of the Chief Actuary, Social Security Administration.

Note: This analysis is based on the intermediate assumptions of the 2004 Social Security trustees' report. Percentage change is calculated as a centered 5-year moving average.

This slowing labor force growth is not always recognized as part of the Social Security debate. Social Security's retirement eligibility dates are often the subject of discussion and debate and can have a direct effect on both labor force growth and the condition of the Social Security retirement program. However, it is also appropriate to consider whether and how changes in pension and/or other government policies could encourage longer workforce participation. To the extent that people choose to work longer as they live longer, the increase in the share of life spent in retirement would be slowed. This could improve the finances of Social Security and mitigate the expected slowdown in labor force growth. It could also help to encourage additional economic growth.

Social Security's Cash Flow Is Expected to Turn Negative in 2018

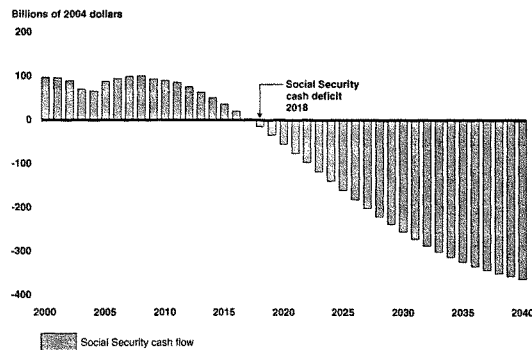
Today, the Social Security Trust Funds take in more in taxes than they spend. Largely because of the known demographic trends I have described, this situation will change. Although the trustees' 2004 intermediate estimates project that the combined Social Security Trust Funds will be solvent until 2042,⁴ program spending will constitute a rapidly growing share of the budget and the economy well before that date. In 2008, the first baby boomers will become eligible for Social Security benefits, and the future costs of serving them have already become a factor in the Congressional Budget Office's (CBO) 10-year projections. Under the trustees' 2004 intermediate estimates, Social Security's cash surplus—the difference between program tax income and the costs of paying scheduled benefits—will begin a permanent decline in 2009. To finance the same level of federal spending as in the previous year, additional revenues and/or increased borrowing will be needed.

By 2018, Social Security's tax income is projected to be insufficient to pay currently scheduled benefits. At that time, Social Security will join Medicare's Hospital Insurance Trust Fund, whose outlays are projected to begin to exceed revenues this year, as a net claimant on the rest of the federal budget. The combined OASDI Trust Funds will begin drawing on the Treasury to cover the cash shortfall, first relying on interest income and eventually drawing down accumulated trust fund assets. The Treasury will need to obtain cash for those redeemed securities either through increased taxes, and/or spending cuts, and/or more borrowing from the public than would have been the case had Social Security's cash flow remained positive.⁵ Neither the decline in the cash surpluses nor the cash deficit will affect the payment of benefits. The shift from positive to negative cash flow, however, will place increased pressure on the federal budget to raise the resources necessary to meet the program's ongoing costs.

⁴Separately, the Disability Insurance (DI) fund is projected to be exhausted in 2029 and the Old-Age and Survivors' Insurance (OASI) fund in 2044.

⁵If the unified budget is in surplus at this point, then financing the excess benefits will require less debt redemption rather than increased borrowing.

Figure 3: Social Security's (OASDI) Trust Funds Face Cash Deficits as Baby Boomers Retire



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration.

Note: These projections are based on the intermediate assumptions of the 2004 Social Security trustees' report.

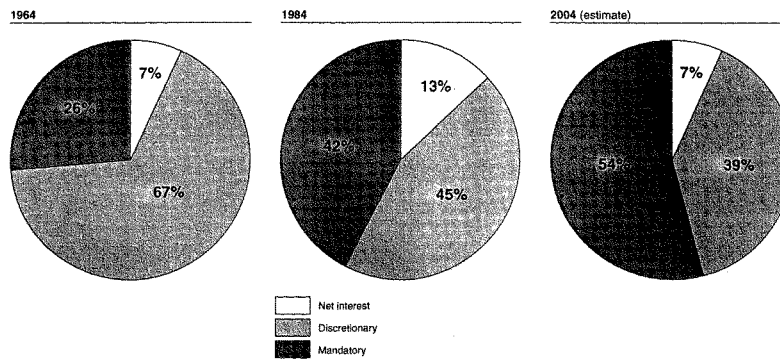
Ultimately, the critical question is not how much a trust fund has in assets, but whether the government as a whole can afford the benefits in the future and at what cost to other claims on scarce resources. As I have said before, the future sustainability of programs is the key issue policy makers should address—i.e., the capacity of the economy and budget to afford the commitment. Fund solvency can help, but only if promoting solvency improves the future sustainability of the program.

Decline in Budgetary Flexibility Absent Entitlement Reform

From the perspective of the federal budget and the economy, the challenge posed by the growth in Social Security spending becomes even more significant in combination with the more rapid expected growth in Medicare and Medicaid spending. This growth in spending on federal entitlements for retirees will become increasingly unsustainable over the longer term, compounding an ongoing decline in budgetary flexibility. Over the past few decades, spending on mandatory programs has consumed an ever-increasing share of the federal budget. In 1964, prior to

the creation of the Medicare and Medicaid programs, spending for mandatory programs plus net interest accounted for about 33 percent of total federal spending. By 2004, this share had almost doubled to approximately 61 percent of the budget. (See fig. 4.)

Figure 4: Federal Spending for Mandatory and Discretionary Programs, Fiscal Years 1964, 1984, and 2004



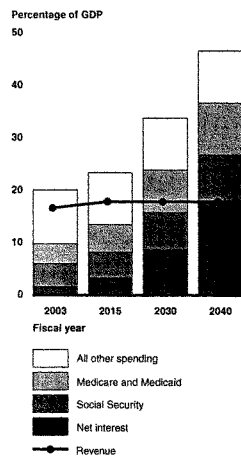
Source: Budget of the United States Government, FY 2005, Office of Management and Budget.

In much of the last decade, reductions in defense spending helped accommodate the growth in these entitlement programs. Even before the events of September 11, 2001, however, this ceased to be a viable option. Indeed, spending on defense and homeland security will likely grow as we seek to combat new threats to our nation's security.

GAO prepares long-term budget simulations that seek to illustrate the likely fiscal consequences of the coming demographic tidal wave and rising health care costs. These simulations continue to show that to move into the future with no changes in federal retirement and health programs is to envision a very different role for the federal government. Assuming, for example, all expiring tax provisions are extended and discretionary spending keeps pace with the economy, by midcentury federal revenues may be adequate to pay no more than interest on the federal debt. To

obtain balance, massive spending cuts, tax increases, or some combination of the two would be necessary. (See fig. 5.) Neither slowing the growth of discretionary spending nor

Figure 5: Composition of Spending as a Share of Gross Domestic Product (GDP), Assuming Discretionary Spending Grows with GDP after 2004 and All Expiring Tax Provisions Are Extended



Source: GAO's March 2004 analysis.

Note: Although expiring tax provisions are extended, revenue as a share of GDP increases through 2014 due to (1) real bracket creep, (2) more taxpayers becoming subject to the Alternative Minimum Tax, and (3) increased revenue from tax-deferred retirement accounts. After 2014, revenue as a share of GDP is held constant.

This testimony is not about the complexities of Medicare, but it is important to note that Medicare presents a much greater, more complex, and more urgent fiscal challenge than does Social Security. Medicare growth rates reflect not only a burgeoning beneficiary population, but also the escalation of health care costs at rates well exceeding general rates of inflation. Increases in the number and quality of health care services have

been fueled by the explosive growth of medical technology. Moreover, the actual costs of health care consumption are not transparent. Third-party payers generally insulate consumers from the cost of health care decisions. These factors and others contribute to making Medicare a much greater and more complex fiscal challenge than even Social Security. GAO has developed a health care framework to help focus additional attention on this important area and to help educate key policy makers and the public on the current system and related challenges.⁶

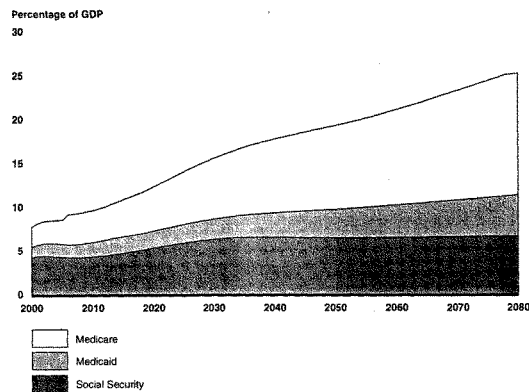
Indeed, long-term budget flexibility is about more than Social Security and Medicare. While these programs dominate the long-term outlook, they are not the only federal programs or activities that bind the future. The federal government undertakes a wide range of programs, responsibilities, and activities that obligate it to future spending or create an expectation for spending. GAO has described the range and measurement of such fiscal exposures—from explicit liabilities such as environmental cleanup requirements to the more implicit obligations presented by life-cycle costs of capital acquisition or disaster assistance.⁷ Making government fit the challenges of the future will require not only dealing with the drivers—entitlements for the elderly—but also looking at the range of federal activities. A fundamental review of what the federal government does and how it does it will be needed.

At the same time it is important to look beyond the federal budget to the economy as a whole. Figure 6 shows the total future draw on the economy represented by Social Security, Medicare, and Medicaid. Under the 2004 Trustees' intermediate estimates and CBO's long-term Medicaid estimates, spending for these entitlement programs combined will grow to 15.6 percent of GDP in 2030 from today's 8.5 percent. Taken together, Social Security, Medicare, and Medicaid represent an unsustainable burden on future generations.

⁶GAO's health care framework can be found at www.gao.gov/cghome/hccrisis/health.pdf. See also U.S. General Accounting Office, *Comptroller General's Forum on Health Care: Unsustainable Trends Necessitate Comprehensive and Fundamental Reforms to Control Spending and Improve Value*, GAO-04-793SP (Washington, D. C.: May 1, 2004).

⁷U.S. General Accounting Office, *Fiscal Exposures: Improving the Budgetary Focus on Long-Term Costs and Uncertainties*, GAO-03-213 (Washington, D.C.: Jan. 24, 2003).

Figure 6: Social Security, Medicare, and Medicaid Spending as a Percentage of GDP



Source: GAO analysis based on data from the Office of the Chief Actuary, Social Security Administration, Office of the Actuary, Centers for Medicare and Medicaid Services, and the Congressional Budget Office.

Note: Social Security and Medicare projections are based on the intermediate assumptions of the 2004 trustees' reports. Medicaid projections are based on CBO's January 2004 short-term Medicaid estimates and CBO's December 2003 long-term Medicaid projections under midrange assumptions.

When Social Security redeems assets to pay benefits, the program will constitute a claim on real resources at that time. As a result, taking action now to increase the future pool of resources is important. To echo Federal Reserve Chairman Greenspan, the crucial issue of saving in our economy relates to our ability to build an adequate capital stock to produce enough goods and services in the future to accommodate both retirees and workers in the future.⁸ The most direct way the federal government can raise national saving is by increasing government saving, i.e., as the economy returns to a higher growth path, a much more balanced and disciplined fiscal policy that recognizes our long-term challenges can help

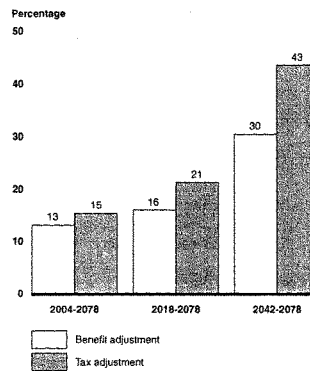
⁸Testimony before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate, July 24, 2001.

provide a strong foundation for future economic growth and can enhance future budgetary flexibility. In the short term, we need to realize that we are already facing a huge fiscal hole. The first thing that we should do is stop digging.

Taking action soon on Social Security would not only promote increased budgetary flexibility in the future and stronger economic growth but would also make the necessary action less dramatic than if we wait. Some of the benefits of early action—and the costs of delay—can be seen in figure 7. This compares what it would take to achieve actuarial balance at different points in time by either raising payroll taxes or reducing benefits.⁹ If we did nothing until 2042—the year the Trust Funds are estimated to be exhausted—achieving actuarial balance would require changes in benefits of 30 percent or changes in taxes of 43 percent. As figure 7 shows, earlier action shrinks the size of the adjustment.

⁹Solvency could also be achieved through a combination of tax and benefit actions. This would reduce the magnitude of the required change in taxes or benefits compared with making changes exclusively to taxes or benefits as shown in figure 7.

Figure 7: Size of Action Needed to Achieve Social Security Solvency



Source: Office of the Chief Actuary, Social Security Administration.

Note: This is based on the intermediate assumptions of the 2004 Social Security trustees' report. The benefit adjustments in this graph represent a one-time, permanent change to all existing and future benefits beginning in the first year indicated.

Thus both sustainability concerns and solvency considerations drive us to act sooner rather than later. Trust Fund exhaustion may be almost 40 years away, but the squeeze on the federal budget will begin as the baby boom generation starts to retire. Actions taken today can ease both these pressures and the pain of future actions. Acting sooner rather than later also provides a more reasonable planning horizon for future retirees.

Evaluating Social Security Reform Proposals

As important as financial stability may be for Social Security, it cannot be the only consideration. As a former public trustee of Social Security and Medicare, I am well aware of the central role these programs play in the lives of millions of Americans. Social Security remains the foundation of the nation's retirement system. It is also much more than just a retirement program; it pays benefits to disabled workers and their dependents, spouses and children of retired workers, and survivors of deceased workers. Last year, Social Security paid almost \$471 billion in benefits to

more than 47 million people. Since its inception, the program has successfully reduced poverty among the elderly. In 1959, 35 percent of the elderly were poor. In 2000, about 8 percent of beneficiaries aged 65 or older were poor, and 48 percent would have been poor without Social Security. It is precisely because the program is so deeply woven into the fabric of our nation that any proposed reform must consider the program in its entirety, rather than one aspect alone. Thus, GAO has developed a broad framework for evaluating reform proposals that considers not only solvency but other aspects of the program as well.

The analytic framework GAO has developed to assess proposals comprises three basic criteria:

- the extent to which a proposal achieves sustainable solvency and how it would affect the economy and the federal budget;
- the relative balance struck between the goals of individual equity and income adequacy; and
- how readily a proposal could be implemented, administered, and explained to the public.

The weight that different policy makers may place on different criteria will vary, depending on how they value different attributes. For example, if offering individual choice and control is less important than maintaining replacement rates for low-income workers, then a reform proposal emphasizing adequacy considerations might be preferred. As they fashion a comprehensive proposal, however, policy makers will ultimately have to balance the relative importance they place on each of these criteria.

Financing Sustainable Solvency

Our sustainable solvency standard encompasses several different ways of looking at the Social Security program's financing needs. While 75-year actuarial balance is generally used in evaluating the long-term financial outlook of the Social Security program and reform proposals, it is not sufficient in gauging the program's solvency after the 75th year. For example, under the trustees' intermediate assumptions, each year the 75-year actuarial period changes, and a year with a surplus is replaced by a new 75th year that has a significant deficit. As a result, changes made to restore trust fund solvency only for the 75-year period can result in future actuarial imbalances almost immediately. Reform plans that lead to sustainable solvency would be those that consider the broader issues of fiscal sustainability and affordability over the long term. Specifically, a

standard of sustainable solvency also involves looking at (1) the balance between program income and costs beyond the 75th year and (2) the share of the budget and economy consumed by Social Security spending.

As I have already discussed, reducing the relative future burdens of Social Security and health programs is essential to a sustainable budget policy for the longer term. It is also critical if we are to avoid putting unsupportable financial pressures on future workers. Reforming Social Security and health programs is essential to reclaiming our future fiscal flexibility to address other national priorities.

Balancing Adequacy and Equity

The current Social Security system's benefit structure attempts to strike a balance between the goals of retirement income adequacy and individual equity. From the beginning, benefits were set in a way that focused especially on replacing some portion of workers' pre-retirement earnings. Over time other changes were made that were intended to enhance the program's role in helping ensure adequate incomes. Retirement income adequacy, therefore, is addressed in part through the program's progressive benefit structure, providing proportionately larger benefits to lower earners and certain household types, such as those with dependents. Individual equity refers to the relationship between contributions made and benefits received. This can be thought of as the rate of return on individual contributions. Balancing these seemingly conflicting objectives through the political process has resulted in the design of the current Social Security program and should still be taken into account in any proposed reforms.

Policy makers could assess income adequacy, for example, by considering the extent to which proposals ensure benefit levels that are adequate to protect beneficiaries from poverty and ensure higher replacement rates for low-income workers. In addition, policy makers could consider the impact of proposed changes on various subpopulations, such as low-income workers, women, minorities, and people with disabilities. Policy makers could assess equity by considering the extent to which there are reasonable returns on contributions at a reasonable level of risk to the individual, improved intergenerational equity, and increased individual choice and control. Differences in how various proposals balance each of these goals will help determine which proposals will be acceptable to policy makers and the public.

**Implementing and
Administering Proposed
Reforms**

Program complexity makes implementation and administration both more difficult and harder to explain to the public. Some degree of implementation and administrative complexity arises in virtually all proposed changes to Social Security, even those that make incremental changes in the already existing structure. However, the greatest potential implementation and administrative challenges are associated with proposals that would create individual accounts. These include, for example, issues concerning the management of the information and money flow needed to maintain such a system, the degree of choice and flexibility individuals would have over investment options and access to their accounts, investment education and transitional efforts, and the mechanisms that would be used to pay out benefits upon retirement. Harmonizing a system that includes individual accounts with the regulatory framework that governs our nation's private pension system would also be a complicated endeavor. However, the complexity of meshing these systems should be weighed against the potential benefits of extending participation in individual accounts to millions of workers who currently lack private pension coverage.

Continued public acceptance of and confidence in the Social Security program require that any reforms and their implications for benefits be well understood. This means that the American people must understand why change is necessary, what the reforms are, why they are needed, how they are to be implemented and administered, and how they will affect their own retirement income. All reform proposals will require some additional outreach to the public so that future beneficiaries can adjust their retirement planning accordingly. The more transparent the implementation and administration of reform, and the more carefully such reform is phased in, the more likely it will be understood and accepted by the American people.

**Examining Social
Security's Effects on
Distribution of
Benefits and Taxes**

Under Social Security, retired workers can receive benefits at age 65 that equal about 50 percent of pre-retirement earnings for an illustrative worker with relatively lower earnings but only about 30 percent of earnings for one with relatively higher earnings. To help ensure that beneficiaries have adequate incomes, Social Security's benefit formula is designed to be "progressive," that is, to provide disproportionately larger benefits, as a percentage of earnings, to lower earners than to higher earners. However, the benefit formula is just one of several program features that influence the way benefits are distributed. Other such program features include provisions for disabled workers, spouses, children, and survivors. Changes in the program over time also affect the

distribution of benefits across generations. So the distribution of Social Security benefits can vary by eligibility, household type, and birth year as well as by earnings level.

Over the past few years, we have been developing an increasing capacity at GAO to estimate quantitatively the effects of Social Security reform on individuals. Such estimates speak directly to applying our second evaluation criterion to reform proposals. We have just issued a new report that, in part, uses such estimates to illustrate the varying effects of different policy scenarios on how Social Security benefits and taxes are distributed relative to earnings levels.¹⁰ Today, I would like to share our findings regarding how to define and describe "progressivity," defining appropriate benchmarks for assessing the future outlook for individuals' Social Security benefits, what factors influence the distributional effects of the current Social Security program, and how various reform proposals might vary in their distributional effects. Still, remember that progressivity is only one of several aspects of our criterion of balancing adequacy and equity, which in turn is only one of three criteria that each consist of several dimensions.

Different Distributional Measures Reflect Different Perspectives

Two distinct perspectives on Social Security's goals suggest different approaches to measuring progressivity. Both perspectives provide valuable insights. An adequacy perspective focuses on benefit levels and how well they help ensure a minimal subsistence or maintain pre-entitlement living standards. For example, replacement rates measure annual benefits as a percentage of annual earnings before receiving benefits. An equity perspective focuses on rates of return and other measures relating lifetime benefits to lifetime contributions. This perspective gauges whether the system gives all participants a "fair deal" on their contributions. The measures themselves describe either adequacy or equity, but their distribution with respect to earnings level describes progressivity. Note however that equity measures cannot accurately assess the distributional effects of reform proposals that rely on general revenue transfers. Such proposals do not generally specify what kind of future taxes or spending cuts will finance the transfers or who will bear the related burden; but evaluating progressivity from an equity perspective requires that all taxes and benefits be clearly allocated.

¹⁰U.S. General Accounting Office, *Social Security: Distribution of Benefits and Taxes Relative to Earnings Level*, GAO-04-747 (Washington, D.C.: June 15, 2004).

**Benchmark Policy
Scenarios Illustrate a
Range of Possible
Outcomes**

Estimating future effects on Social Security benefits should reflect the fact that the program faces a long-term actuarial deficit and benefit reductions and/or revenue increases will be necessary to restore solvency. To illustrate a full range of possible outcomes, we developed hypothetical benchmark policy scenarios that would restore solvency over the next 75 years either by only increasing payroll taxes or by only reducing benefits. Our tax-increase-only benchmark simulates "promised benefits," or those benefits defined under current law, while our benefit-reduction-only benchmarks simulate "funded benefits," or those benefits for which currently scheduled revenues are projected to be sufficient. The benefit reductions are phased in between 2005 and 2035 to strike a balance between the size of the incremental reductions each year and the size of the ultimate reduction. At our request, Social Security actuaries scored our benchmark policies and determined the parameters for each that would achieve 75-year solvency. For our benefit reduction scenarios, the actuaries determined these parameters assuming that disabled and survivor benefits would be reduced on the same basis as retired worker and dependent benefits. If disabled and survivor benefits were not reduced at all, reductions in other benefits would be deeper than shown in this analysis.¹¹

**Program's Distributional
Effects Reflect Various
Program Features and
Demographic Patterns**

Social Security's distributional effects reflect program features, such as its benefit formula, and demographic patterns among its recipients, such as marriage between lower and higher earners. The retired worker benefit formula favors lower earners by design, replacing about 50 percent of pre-retirement earnings at age 65 for an illustrative low earner but only about 30 percent of pre-retirement earnings for an illustrative high earner.¹² (See fig. 8.) The disability benefit formula also favors lower earners, and disability recipients are disproportionately lower earners. Our simulations suggest that for individuals born in 1985, compared with a hypothetical program without disability insurance, Social Security's disability

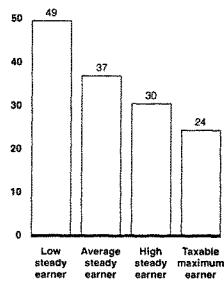
¹¹For more details on the alternative benefit-reduction benchmarks, see appendix I in U.S. General Accounting Office, *Social Security: Distribution of Benefits and Taxes Relative to Earnings Level*, GAO-04-747 (Washington, D.C.: June 15, 2004).

¹²The annual trustees' report uses illustrative "scaled earnings" patterns. The values of the replacement rates for these scaled earnings patterns at age 65 are virtually identical to the ones presented in figure 1. See The Board of Trustees, Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds, *The 2004 Annual Report of the Board of Trustees of the Federal Old-Age and Survivors Insurance and Disability Insurance Trust Funds* (Washington, D.C.: Mar. 23, 2004), pp. 186-187.

provisions increase lifetime Social Security benefits for the bottom fifth of earners by 43 percent, compared with 14 percent for the top fifth of earners. The extent to which the benefit formula and disability benefits favor lower earners may be offset to some degree by demographic patterns. Household formation tends to reduce the system's tilt toward lower earners because some of the lower-earning individuals helped by the program live in high-income households. For example, many of the lower-earning individuals that the system favors through spouse and survivor benefits actually live at some point in higher-income households because of marriage. In our simulations, the ratio of benefits received to payroll taxes contributed is higher for lower earners than for higher earners, but this difference is reduced when we account for household formation. Also, differences in mortality rates may reduce rates of return for lower earners, as studies show they may not live as long as higher earners and therefore would receive benefits for fewer years.

Figure 8: Social Security Benefit Formula Provides Higher Replacement Rates for Lower Earners

Percentage replacement rate at age 65
60



Source: GAO analysis using SSA ANYPIA program.

Note: Replacement rates are the annual retired worker benefits at age 65 for workers born in 1985 divided by the earnings in the previous year. For such workers, the full retirement age will be 67. Steady earners have earnings equal to a constant percentage of Social Security's Average Wage index in every year of their careers. Those percentages are 45, 100, and 160, respectively, for low, average, and high earners. Taxable maximum earners have earnings equal to the maximum taxable earnings in each year. Replacement rates are simulated under the tax-increase benchmark (promised benefits); they would be lower under the proportional benefit-reduction benchmark by a constant proportion and would therefore show a similar pattern. See appendix I for more on the benchmark policy scenarios.

Distributional Effects Vary across Reform Proposals

Alternative Social Security reform proposals would have different distributional effects, reflecting the variety of provisions in them. The various provisions include different ways, within the current program structure, of reducing certain benefits, enhancing selected benefits, and enhancing revenues. The various reform provisions also include creating a new system of individual retirement savings accounts with different account contribution levels and different ways of adjusting Social Security defined benefits to reflect the diversion of Social Security contributions into the accounts. Individually and in combination, these provisions would affect the distribution of benefits and taxes relative to earnings levels.

For example, Model 2 of the President's Commission to Strengthen Social Security (CSSS) proposes a new system of voluntary individual accounts along with a combination of certain benefit reductions for all beneficiaries and selected benefit enhancements for selected low earners and survivors. One of its provisions would reduce Social Security defined benefits proportionally for all workers by modifying the benefit formula. At the same time, benefits would be enhanced for certain lower earners and surviving spouses, and 4 percentage points of individuals' payroll taxes (up to a \$1,000 annual limit¹⁵) would be diverted into individual accounts.

In contrast, a proposal offered by Peter Diamond and Peter Orszag would also include a provision to reduce Social Security defined benefits proportionally for all workers by modifying the benefit formula. It also has provisions to enhance benefits for selected lower earners and surviving spouses. However, it does not contain a provision for individual accounts, and it does have a variety of provisions for enhancing revenues. The Diamond-Orszag proposal also has other benefit reduction and benefit enhancement provisions, such as modifying the benefit formula to reduce benefits for higher earners only. Another provision would maintain disability benefits and benefits for survivors of workers who die before retirement in spite of the other benefit reductions.

Also in contrast to CSSS Model 2, a proposal offered by Peter Ferrara provides for a new system of voluntary individual accounts but does not contain any provisions to make changes to Social Security defined benefits, except for individuals participating in the individual accounts. Moreover, it would provide for substantially larger contributions to the accounts than would the CSSS Model 2 proposal. Under this provision, individual account contributions would be a larger percentage of payroll for lower earners than for higher earners. Also, for those who participate in the accounts, Social Security defined benefits would be reduced to reflect the payroll taxes redirected into the accounts; this account offset uses a different formula than does CSSS Model 2.

To illustrate the distributional effects of CSSS Model 2, we used a microsimulation model to estimate benefits under it and under our benchmark policy scenarios. We did not examine the distribution of equity measures such as benefit-to-tax ratios or rates of return, because the

¹⁵The limit on account contributions would grow over time at the same rate as wages.

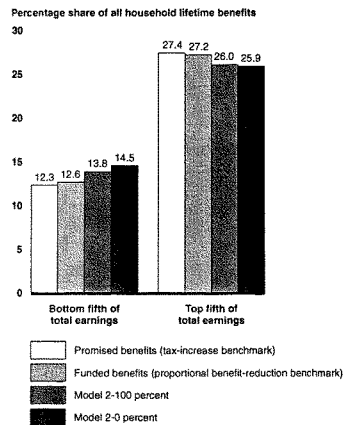
proposal's individual account feature requires general revenue transfers.¹⁴ Since account participation is voluntary, we used two simulations to examine the effects of the Model 2 provisions, one with universal account participation (Model 2-100 percent) and one with no account participation (Model 2-0 percent). We also assumed that all account participants would invest in the same portfolios; consequently we did not capture any distributional effect that might occur if lower earners were to make different account participation or investment decisions than higher earners.¹⁵

According to our simulations, the distribution of benefits under Model 2 could favor lower earners more than the distribution of benefits under either currently promised or currently funded benefits. For example, assuming universal account participation, households in the lowest fifth of earnings may receive about 14 percent of all lifetime benefits under Model 2, compared with about 12.5 percent under the current program. (See fig. 9.)

¹⁴See U.S. General Accounting Office, *Social Security Reform: Analysis of Reform Models Developed by the President's Commission to Strengthen Social Security*, GAO-03-310 (Washington, D.C.: Jan. 15, 2003), p. 24.

¹⁵Each participant has portfolio allocation of 50 percent in equities, 30 percent in corporate bonds, and 20 percent in U.S. Treasury long-term bonds. All portfolios earn a constant 4.6 percent real rate of return. For sensitivity analysis, we also simulated scenarios with rates of return varying stochastically across individuals and with higher and lower returns to equities. Shares of benefits by quintiles of lifetime earnings were very similar under all specifications.

Figure 9: CASS Model 2 Might Favor Lower Earners More than Benchmarks for Individuals Born in 1985



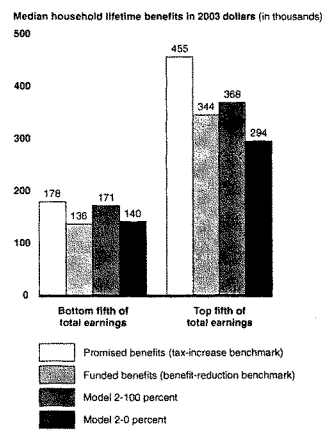
Source: GAO analysis using the GEMINI model.

Note: Earnings fifths are based on the present value of total household lifetime earnings. Household analysis is based on per capita benefits, taxes, and earnings. This includes all sample members who survive past age 24. It assumes all account participants choose the same portfolio—50 percent equities, 30 percent corporate bonds, and 20 percent Treasury bonds. Accounts earn a constant real return of 4.6 percent. For sensitivity analysis, we also simulated scenarios with rates of return varying stochastically across individuals and over time and scenarios with higher and lower returns to equities. Shares of benefits by earning fifths were similar under all specifications.

It should be noted that while the simulations suggest that the distribution of benefits under Model 2 is more progressive than under the benchmarks, this does not mean benefit levels are always higher for the bottom fifth under Model 2. Progressivity is about how the "pie" is divided up, not about how big the pie is. So, while Model 2 may improve the relative position of lower earners, it may not improve the adequacy of their benefits. (See fig. 10.) According to our simulation, median household lifetime benefits for the bottom fifth under Model 2-0 percent would be 3 percent higher than under the funded benefits scenario but 21 percent lower than under the promised benefits scenario. Median household

lifetime benefits for the bottom fifth under Model 2-100 percent would be 26 percent higher than under the funded benefits scenario but 4 percent lower than under the promised benefits scenario.

Figure 10: Median Household Lifetime Benefits under Model 2 and the Benchmarks for Individuals Born in 1985



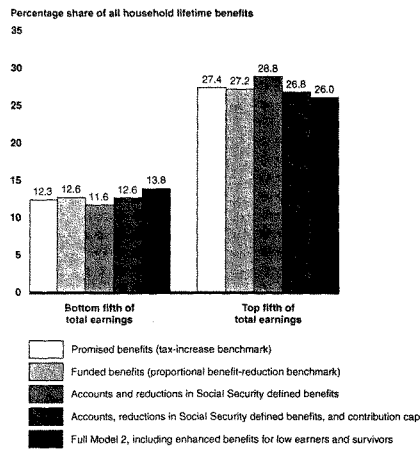
Source: GAO analysis using the GEMINI model.

Note: Earnings fifths are based on the present value of total household lifetime earnings. Household analysis is based on per capita benefits, taxes, and earnings. This includes all sample members who survive past age 24. It assumes all account participants choose the same portfolio—50 percent equities, 30 percent corporate bonds, and 20 percent Treasury bonds. Accounts earn a constant real return of 4.6 percent.

We also simulated each of Model 2's core features, assuming 100 percent participation in the individual accounts, to illustrate the distributional effect of each feature. (See fig. 11.) First we simulated a version of Model 2-100 percent that included the individual accounts and the reductions in Social Security defined benefits, but not the \$1,000 cap on account contributions or the enhanced benefits for low earners and survivors. Next we simulated a version that included the defined-benefit reductions and

the individual accounts with the \$1,000 cap on account contributions. Finally, we simulated the complete Model 2-100 percent scenario, which included the enhanced benefits to lower earners and survivors. While the proposal's individual accounts and benefit reductions together may favor higher earners, this is more than offset by a limit on account contributions and the enhanced benefits for low earners and survivors. Again, this assumes that all account participants would invest in the same portfolios. However, if individuals' investment decisions varied by earnings level, then the distribution of income from the accounts would differ from our simulations.

Figure 11: CSSS Model 2's Contribution Cap and Enhanced Benefits for Lower Earners and Survivors Offset the Distributional Effect of the Accounts and Reductions in Social Security Defined Benefits



Source: GAO analysis using the GEMINI model.

Note: Earnings fifths are based on the present value of total household lifetime earnings. Household analysis is based on per capita benefits, taxes, and earnings. This includes all sample members who survive past age 24 and assumes 100 percent account participation with all account participants choosing the same portfolios—50 percent equities, 30 percent corporate bonds, and 20 percent Treasury bonds. Accounts earn a constant real return of 4.6 percent.

It should be emphasized that these simulations are only for individuals born in 1985,¹⁶ and the distributional impact of Model 2 could be different for individuals born in later years. For example, under the proposal, initial

¹⁶In our modeling, we focused on workers born in 1985 because all prospective program changes under all alternative policy scenarios would be almost fully phased in for such workers.

Social Security defined benefits only grow with prices, while initial benefits from account balances grow with wages. Since wages generally grow faster than prices, Social Security defined benefits will decline as a proportion of total benefits, reducing the importance of the progressive benefit formula, disability benefits, and the enhanced benefits for low earners and survivors.

It should also be noted that the account feature of Model 2-100 percent likely exposes recipients to greater financial risk. Greater exposure to risk may not affect the shares of benefits received by the bottom and top fifths of earnings.¹⁷ However, greater risk may be more problematic for lower earners, who likely have fewer resources to fall back on if their accounts perform poorly.¹⁸

Conclusion

By design, Social Security distributes benefits and contributions across workers and their families in a variety of ways. These distributional effects illustrate how the program balances the goal of helping ensure adequate incomes with the goal of giving all workers a fair deal on their contributions. Any changes to Social Security would potentially alter those distributional effects and the balance between those goals. Therefore, policy makers need to understand how to evaluate distributional effects of alternative policies.

Several key themes inform this understanding. First, it should be noted that greater benefit progressivity is not the same thing as greater benefit adequacy. Under some reform scenarios, Social Security could distribute benefits more progressively than under current law while providing lower, less adequate benefits. Secondly, our analysis illustrates that it is possible for some reform provisions that may not favor lower earners to be counterbalanced by other, more favorable ones. Finally, benefit progressivity is only one of several aspects of balancing adequacy and equity. As our framework suggests, besides balancing adequacy and equity, a proposal's effect on the economy and whether it achieves sustainable

¹⁷We simulated an alternative version of Model 2-100 percent where the return to equities varied stochastically across individuals and over time. Shares of benefits by earnings quintile were almost identical to the scenario that assumed constant returns to equities.

¹⁸Lower earners may be more risk averse than higher earners and therefore suffer greater utility loss from increased risk.

solvency should also be considered, as well as how readily it could be implemented and explained to the public.

As we have noted in the past before this committee and elsewhere, a comprehensive evaluation is needed that considers a range of effects together. Focusing on comprehensive packages of reforms will enable us to foster credibility and acceptance. This will help us avoid getting mired in the details and losing sight of important interactive effects. It will help build the bridges necessary to achieve consensus.

The fundamental nature of the program's long-term financing challenge means that timely action is needed. I believe it is possible to craft a solution that will protect Social Security benefits for the nation's current and near-term retirees, while ensuring that the system will be there for future generations. Stated differently, I believe that it is possible to reform Social Security in a way that will assure the program's solvency and sustainability while exceeding the expectations of all generations of Americans. In this regard, the sooner we act, the greater the opportunity to achieve this desirable outcome. It is my hope that we will think about the unprecedented challenge facing future generations in our aging society. We need to act now before the approaching demographic tidal wave makes the imbalances more dramatic and meaningful reform less feasible. We at GAO look forward to continuing to work with this Committee and the Congress in addressing this and other important issues facing our nation. In doing so, we will be true to our core values of accountability, integrity, and reliability.

Mr. Chairman, and members of the Committee, that concludes my statement. I'd be happy to answer any questions you may have.

GAO Contact and Staff Acknowledgments

For information regarding this testimony, please contact Barbara D. Bovbjerg, Director, Education, Workforce, and Income Security Issues, at (202) 512-7215. Individuals making key contributions to this testimony include Ken Stockbridge, Charles Jeszeck, and Gordon Mermin.

Related GAO Products

Social Security: Distribution of Benefits and Taxes Relative to Earnings Level (GAO-04-747, June 15, 2004).

Social Security Reform: Analysis of a Trust Fund Exhaustion Scenario (GAO-03-907, July 29, 2003)

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Social Security: Analysis of Issues and Selected Reform Proposals, (GAO-03-376T, Jan. 15, 2003).

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The CHAIRMAN. David, thank you very much for that presentation and, more importantly, the study that you have just completed. I think this goes along with where we are going in this Committee, and that is to build a solid base of information, analytical information, as Congress moves ultimately toward reform of the Social Security system.

Before I do questions, David, we have been joined by Senator Kohl.

Herb, do you wish to make any comment beforehand?

Senator KOHL. No.

The CHAIRMAN. Then let me start with questions, and you might have questions yourself, Herb.

Mr. Walker, after doing all this research on redistribution issues for Social Security and personal retirement accounts, what are probably the most important things we should walk away with looking at this study?

Mr. WALKER. Well, first, there is a difference between progressivity and adequacy. I think that is an important point. Second, when you are looking at progressivity, you need to consider it not just from the benefit-level standpoint, but also tax burdens; and, third, that individual account plans can, depending upon what their design is, improve progressivity, but you also need to consider the effect from the other dimensions; and last, I would say, there can be differences between individuals and households.

The CHAIRMAN. Yes. That was going to be my next question. Elaborate on that just a little bit if you would, the analysis and the redistribution effects.

Mr. WALKER. Progressivity tends to be a little bit less from a household standpoint than on an individual basis, and the reason being is because of family patterns. You can have low-income individuals join a household that has higher-income workers, and therefore it tends to moderate the distributional effects. Marriage is probably the best example of how that can have an effect, and having been married 33 years, I understand how this can happen.

The CHAIRMAN. That is exactly the effect that happens as a result of that, OK.

If the funds used to transition to a personal retirement account proposal such as in Model 2 are temporary, would it be reasonable to consider the funds as an investment in a sustainable system? How do we look at that?

Mr. WALKER. I would not look at it as an investment. I do think it is, however, appropriate to look at the discounted present value cost of various reform proposals. One of the challenges that we have in the United States is the way we keep score. The way we currently keep score provides a misleading view of really where we stand and what the real economic cost is of various reform proposals. So I think that you need to look not only as to the budgetary commitment, but what is the discounted present value cost of various reform proposals in current dollar terms.

For example, right now, assuming that you want to end up delivering on all the benefits that have been promised under Social Security today, and I am not saying that is true, but if that is true, it is going to take an additional \$4.9 trillion to be able to deliver on that for the next 75 years. Now, that number is gross, not net

of the bonds in the trust fund. Each of those other reform proposals will require different amounts of money as well, and so I think we need to think about the discounted present value cost, which is typically how economists would look at it and typically also how you would look at it from an accounting standpoint.

The CHAIRMAN. Yes. That is a point well made.

Your report briefly discusses general revenue transfers and the problem of assigning distributional effects. Can you elaborate on the general distribution effect if income taxes are used to finance the transfers?

Mr. WALKER. Well, in general, as you know, Mr. Chairman, income taxes tend to be more progressive in nature. Payroll taxes tend to be very regressive in nature, and so you would have to say that in general terms, if you are going to use an incomes tax versus a payroll tax, the income tax would be a more progressive approach. I think it is, however, important to note that based upon GAO's long-range budget simulations, we face a large and growing structural deficit, and we are going to have to address how we are going to close the gap whether through spending cuts, whether through the tax side, and, if so, whether or not it is going to be income taxes, payroll taxes, consumption taxes. The Congress will ultimately have to decide.

The CHAIRMAN. OK. GAO talks about the twin goals of adequacy as equity as important considerations in any reform to strengthen Social Security. There are some who suggest that we shouldn't ask one system to achieve both goals. What is your thinking on that issue?

Mr. WALKER. I think it is important to look at four dimensions: Sustainable solvency, adequacy, equity, and administrative feasibility. Yes, there are challenges and tradeoffs between looking at those, but I think it is important to look at all four dimensions.

The CHAIRMAN. What you are saying is, as we reform, we have got to look through all four of those lenses, if you will, to get the right one.

Mr. WALKER. I agree, Mr. Chairman. I think we have to look at all four. I think others will evaluate your proposals either for the positive or the negative, looking at all four, and failure to look at all four, I think exposes any potential reform to potential criticism and could slow needed reforms.

The CHAIRMAN. OK. Thank you very much.

Let me turn to Senator Kohl. Any questions?

Senator KOHL. Thank you very much, Mr. Chairman.

Mr. Walker, did you put a number of transition costs?

Mr. WALKER. Yes, sir, we did, based upon our assumptions. Right now, if you look at, for example, the three proposals, under the Model 2 of the President's Commission, it is my understanding that the discounted present value cost for the transition obligation over the next 75 years would be \$2.3 trillion. Now, that is gross. That is not considering the bonds that are in the trust fund, but it is also important to note that the other two proposals we looked at would also require some general revenue funding. The most would be the Ferrara approach. We estimated that it would take about \$6.9 trillion in discounted present dollar terms.

Senator KOHL. So we are talking about, no matter how you want to apportion it out, it is a tremendous amount of money to get to where it is we would like to go. This is not cost-free in any way.

Mr. WALKER. You are exactly right, Senator, but I also think it is important to know that right now, we have about a \$4.9 trillion shortfall. Now, that is gross. Net of the bonds in the trust fund, it is 3.7 trillion, but as you both know, the bonds in the trust fund are going to require additional revenues. We have already spent the money.

Senator KOHL. No question.

Mr. WALKER. So we are going to have to somehow come up with the revenues to deal with it.

Senator KOHL. No question about it. When you look at the present formulas that are used with respect to Social Security, while I am not advocating it, I heard people talk about the fix that we could attach to Social Security by raising the threshold. Are you familiar with how much we could help Social Security in terms of its solvency by raising the threshold from where it is, which I think is about 86 or 87 thousand dollars?

Mr. WALKER. You mean the taxable wage base? I don't have the numbers in front of me, Senator Kohl. I would be happy to provide that for the record, what we have.

Senator KOHL. Yes. I am assuming, perhaps incorrectly, that you have done some examination of what would happen if we decided to bite the bullet and raise the threshold, let us say, from 87 to 150.

Mr. WALKER. There is work that has been done on that by us and by others, and I would be happy to provide something for the record. I mean, there are various reform proposals, whether it is raising the retirement age, whether it is increasing the taxable wage base, whether it is modifying the benefit formula that can help to show you how far you get under the different proposals, and I do think it is important to keep in mind that from a funding standpoint and from a degree of imbalance, Social Security is a much easier problem to deal with than some of the other ones you are going to have to deal with, especially Medicare.

Senator KOHL. I agree.

Mr. WALKER. For example, if you look at the discounted present value underfunded liability for Social Security, it is about \$3.7 trillion, net of the bonds in the trust fund. If you look at Medicare, it is about \$27.8 trillion, net of the bonds in the trust fund. So I think one of the things that we need to consider is not just what needs to be done to assure solvency and sustainability of Social Security for current and future generations, but to the extent that you do things for Social Security, for example on the revenue side, then how is that going to affect what you are going to be able to do for Medicare? The gap is much greater in Medicare.

I do believe and I think it is important to look at some other dimensions, such as the normal retirement age, such as the replacement rates, such as the indexing. Having been a trustee of Social Security and Medicare before, I spent a fair amount of time looking at reform proposals, and the good news is I really do believe you can reform this Social Security and exceed the expectations of every generation. I really do believe that.

Senator KOHL. I think that is a good point, and I think it is a point well worth making and repeating, because the public is not aware that the Social Security problems are not nearly as serious as the Medicare problems in terms of funding. I think if you took a survey out there, most people would think Social Security problems are the biggest problems we face looking forward. Medicare problems are by far much bigger.

Mr. WALKER. Medicare is seven times greater on relative terms, based on the numbers that I gave you.

Senator KOHL. Thank you, Mr. Chairman.

The CHAIRMAN. Herb, thank you for those questions.

David, you are obviously not the first to tell us of the reality of the problems, and that is obviously why we continue to hold these hearings and build this informational base, because you are right. When you are dealing with a dynamic environment versus a relatively static or fixed environment where you can lock in numbers and they work in relation to Social Security versus Medicare, the world changes significantly, and we are sitting here as we attempt to tackle health care; we are also dealing with a phenomenally moving target that is dynamic in its character, and we can make projections, but we all know that one new discovery out there, one new application significantly changes costs, positive or negative, as we deal with health care.

Mr. WALKER. It is a lot easier to get a handle on the estimated cost of Social Security than it is for health care for the reasons that you mention and others. I agree.

The CHAIRMAN. But I am pleased with your optimism about the reality of reform in Social Security, because I am very frustrated and have been for some years that we are going to tell our grandchildren that if we don't reform it, it is really going to be a significantly bad investment for them as it relates to the amount of money coming in versus the reality of money that would come out to them. I am saying that in a comparative way to my parents that are in their eighties and still alive where Social Security was just a phenomenal investment for them, and somehow Herb and I are going to try to fix that.

Mr. WALKER. One of the reasons I say that is because myself, having two children and two grandchildren and also having done an extensive amount of outreach on this issue outside of Washington, I find that the people that are most fearful about Social Security reform are current retirees and people that are approaching retirement. From a practical standpoint, they are really not going to be affected by the reform.

The CHAIRMAN. That is right.

Mr. WALKER. It is really going to be the children and the grandchildren, our children and grandchildren and future generations, and for them, they are discounting Social Security to a greater extent than they should. Therefore, that means there is an opportunity to structure reforms, with or without individual accounts, in a way that everybody gets more than they think they are going to get. I would call that a win and a desirable outcome, and the sooner, the better.

The CHAIRMAN. I think you are right.

Well, thank you very much for your time, your participation, and the work that has been done. I think that this report, again, builds on that base of knowledge that we need to have as we move forward on Social Security reform.

Mr. WALKER. Thank you, Mr. Chairman and Senator Kohl. It was a pleasure to be with you.

The CHAIRMAN. Now let me call our second panel forward, please.

Again, for the record and the listener, we have on our second panel Peter Ferrara of the Institute for Policy Innovation and the Club for Growth; Dr. Jeffrey Brown, professor of Finance from the University of Illinois at Urbana-Champaign; Jeff Lemieux, executive director for Centrists.Org, Washington DC, think tank; and Dr. Christian Weller, senior economist for the Center for American Progress here in Washington, DC.

Gentlemen, thank you all for being with us this morning. Peter, let us start with you.

STATEMENT OF PETER FERRARA, INSTITUTE FOR POLICY INNOVATION AND THE CLUB FOR GROWTH, WASHINGTON, DC

Mr. FERRARA. Thank you very much, Senator, for inviting me this morning.

I am here to discuss a proposal, a progressive proposal providing a progressive option for personal retirement accounts as a choice as compared to Social Security. The option provides for a large personal retirement account, and the option is designed to be progressive, which means that lower-income workers can contribute a higher percentage of their taxes to the account than higher-income workers. So the option provides specifically that out of the 12.4 percent current Social Security payroll tax, workers could take 10 percentage points of that 12.4 on the first \$10,000 of their wage income each year and 5 percentage points on their taxable wage income after that. That comes out to an average of 6.4 percentage points of the 12.4 that would go into the personal accounts, a much larger account than has been proposed before, with lower-income workers contributing a higher percentage above that and higher-income workers being able to transfer a lower percentage.

The proposal makes no change in disability and survivors benefits at all, and there is no change in Social Security benefits otherwise for anybody at any point now or in the future. Because the advantages of a large personal account are so great, no other changes are necessary. I discuss in detail in my written testimony how this structure mirrors the progressivity of social security. It preserves within the personal account the progressivity of Social Security so that workers across the board would gain roughly the same percentage depending on their investment portfolio, and I will go into that in more detail.

There are five ways I think in which this proposal in addition enhances progressivity for low- and moderate-income workers. First of all, it sharply increases future retirement benefits for low- and moderate-income workers. Large accounts do that much more than any other alternative. Because of the bigger accounts, they are able to take more advantage of the better return in the private sector, and so they provide very sharp increases. Again, I detail that in my

written testimony, but for a worker where they invest over a lifetime half and half in stocks and bonds at standard market investment returns, I calculate that they would gain a benefit increase of two-thirds compared to currently promised Social Security benefits. In other words, at standard market investment returns, investing half in stock and half in bonds, workers across the board, and low- and moderate-income workers in particular, would gain a benefit increase of two-thirds as compared to what Social Security promises, let alone what it can pay. If they invested two-thirds in stocks and one-third in bonds, the benefits they would gain would double what Social Security promises but cannot pay.

So you see potentially very large increases and a large, large margin for error. So then in addition to that, in terms of rates of return analysis, you would get far higher rates of return through the large personal accounts than you would through the current Social Security system. Again, based on a number of studies that I have done in the past and others, I estimate for most workers today, the real rate of return promised by Social Security, let alone what it could pay, is one to 1.5 percent; the long-term return on corporate bonds, real return, three to three and a half percent; on stocks, I think the record will bear out seven to seven and a half percent.

So much higher returns, and you see what we have done here is a vast improvement both on the basis of adequacy and of equity, because the returns are much higher and the future benefits are much higher. Also under the reform plan, low- and moderate-income workers would gain much greater accumulations of personal wealth than under Social Security. The chief actuary of Social Security has already officially scored this plan. He estimates that by 15 years after the reform plan is adopted, working people would have gained \$7 trillion in today's dollars in their own personal accounts. Again, that is the chief actuary's number. You see, this is the greatest advantage and break for working people that we could possibly adopt today, \$7 trillion accumulated in just the first 15 years in the personal accounts of working people.

I detail in the written testimony of some of the gains you could expect: average workers, 300 to \$400,000; lower income workers, 270,000 to 350,000, depending on what portfolios they invest in, how much in stocks, how much in bonds. So again, it is more progressive because it lets workers accumulate much more money. It is more progressive because it lets worker get better benefits. It is more progressive because it lets low- and moderate-income workers get higher returns.

Also, these much larger accumulations of personal wealth by low- and moderate-income workers would greatly broaden wealth ownership in our nation and sharply reduce the concentration of wealth. That \$7 trillion is relatively equally distributed across the board, especially as compared to our current distribution of wealth. If you add wealth to the current wealth, it greatly reduces the concentration of wealth, again, one of the most progressive reforms that we could possibly have on that score. Nothing else in prospect would so greatly reduce the concentration of wealth.

In addition, the reform plan addresses another problem that harms low-income workers, which is lower life expectancies. If they

die before they reach retirement or just after, they lose everything, but with the personal accounts, they would have that money and they would accumulate.

Finally, I would submit that on these five measures, the large personal accounts do much more, are much more progressive, than either the Diamond-Orszag plan, which achieves virtually none of these, or the smaller accounts proposed in Commission Option 2. Because the accounts are smaller, the net gains in these areas are not nearly as large.

Thank you very much.

[The prepared statement of Mr. Ferrara follows:]

Testimony of

Peter J. Ferrara

Senior Fellow
Institute for Policy Innovation

Director, Social Security Project
Club for Growth

Progressive Personal Accounts for Social Security

Before the Senate Aging Committee
June 15, 2004

Executive Summary

The Progressive Personal Account reform plan would allow lower income workers to contribute a larger portion of their Social Security taxes to personal accounts than higher income workers. The reform plan provides for a large personal account overall enabling workers on average to contribute 6.4 percentage points of the current 12.4% Social Security payroll tax to the accounts.

The reform plan roughly mirrors the progressivity of the current Social Security system, with workers across the board enjoying relatively equal net gains for equivalent investment portfolios. Moreover, the plan would enhance progressivity in the following ways:

- It would sharply increase future retirement benefits for low and moderate income workers.
- It would pay far higher, market based rates of return for workers across the board than Social Security now offers. As a result, the plan would sharply improve both benefit adequacy and equity.
- Under the reform plan, low and moderate income workers would gain much greater accumulations of personal wealth than under Social Security.
- These much larger accumulations of personal wealth by low and moderate income workers would greatly broaden wealth ownership in our nation, and sharply reduce the concentration of wealth.
- The reform plan addresses the problem of those with lower life expectancies, who tend to be those with lower incomes, suffering lower returns and lifetime benefits as a result.

Indeed, the Progressive Personal Retirement Account plan is more progressive on these grounds than either the Diamond-Orszag plan (which does nothing to increase the personal wealth of working people), or the much smaller accounts proposed in Option 2 of the 2001 reform commission.

Components of the Reform Plan

Last summer, I authored a study published by the Institute for Policy Innovation which proposed a progressive personal account option for Social Security.¹ The main components of the reform plan are as follows:

- Out of the 12.4% Social Security payroll tax, workers would be free to choose to shift to personally owned, individual accounts, 10 percentage points on the first \$10,000 in wages each year, and 5 percentage points on all wages above that, to the maximum Social Security taxable income. This creates a progressive structure with an average account contribution among all workers of 6.4 percentage points
- Benefits payable from the tax free accounts would substitute for a portion of Social Security benefits based on the degree to which workers exercised the account option over their careers. Workers exercising the personal accounts would receive Recognition Bonds guaranteeing them the payment of Social Security retirement benefits based on the past taxes they have already paid into the program. Workers would then also receive in addition the benefits payable through the personal accounts.
- Workers choose investments by picking a fund managed by a major private investment firm, from a list officially approved for this purpose and regulated for safety and soundness, similarly to the operation of the Federal Employee Thrift Retirement System.
- The accounts are backed up by a safety net guaranteeing that workers would receive at least as much as Social Security promises under current law.
- Apart from this personal account option, there would be no change in currently promised Social Security benefits of any sort, for today's seniors, or anyone in the future. Anyone who chooses to stay in Social Security would receive the benefits promised under current law. Survivors and disability benefits would continue as under the current system unchanged.

Critically, the unique structure of this reform plan **maintains both a defined benefit and a defined contribution benefit structure for workers in the same system.** Guaranteeing that all workers would receive at least the benefits promised under current law maintains the current defined benefit structure for all workers. Yet, the defined contribution benefits of the personal accounts provide a high probability that all workers across the board would get much higher benefits from the accounts.

Moreover, the reform plan maintains insurance protection for workers while adding savings and investment. The plan requires each worker at retirement to use the funds in his or her account to purchase an annuity providing at least the benefits promised by Social Security.

¹ Peter Ferrara, A Progressive Proposal for Social Security Personal Accounts, Institute for Policy Innovation, Policy Report 176, June 2003.

That annuity provides insurance protection against living too long. Moreover, the survivors and disability insurance of the current system is continued without change.

The transition under the reform is financed by 4 factors:

1. Short term Social Security surpluses projected until 2018.
2. Reducing the rate of growth of Federal spending by 1 percentage point per year for 8 years, and devoting those savings to the transition. The proposal would consequently involve a Federal spending limitation measure providing for this reasonable and moderate spending restraint. The proposal, therefore, provides a vehicle for beginning to get runaway Federal spending under control. The spending savings for those years are maintained until all short term debt issued to fund the transition is paid off in full.
3. The revenue feedback from increased saving and investment in the accounts due to taxation of increased investment returns at the corporate level, as developed by Harvard Prof. Martin Feldstein and former Sen. Phil Gramm for his legislative proposal;
4. To the extent needed, the sale of surplus Social Security trust fund bonds. This just involves paying Social Security back for all the surpluses it has lent to the Federal government in the past for other government spending. Under the current system, those bonds are just going to be redeemed for cash from the Federal government anyway after 2018, until the trust fund is exhausted in 2042.

The Official Score of the Reform Plan by the Chief Actuary of Social Security

This proposal has already been scored by the Chief Actuary of Social Security.² That official score shows:

- **The large personal accounts in the plan are sufficient to completely eliminate Social Security deficits over time, without any benefit cuts or tax increases.** That is because so much of Social Security's benefit obligations are ultimately shifted to the accounts. As the Chief Actuary stated, under the reform plan, "the Social Security program would be expected to be solvent and to meet its benefit obligations throughout the long-range period 2003 through 2077 and beyond."³ **Indeed, the eventual surpluses from the personal accounts are large enough to eliminate the long term deficits of the disability insurance program as well, even though the reform plan does not otherwise provide for any changes in that program.**

² Estimated Financial Effects of the Progressive Personal Account Plan, December 1, 2003, Office of the Actuary, Social Security Administration; Additional Estimated Financial Effects of the Progressive Personal Account Plan, April 6, 2004, Office of the Actuary, Social Security Administration

³ Id., p. 1.

- The accounts achieve this not only with no benefit cuts or tax increases in Social Security. **Over time, in fact, the accounts would provide substantially higher benefits, as well as tax cuts.** The official score shows that by the end of the 75 year projection period, instead of increasing the payroll tax to over 20% as would be needed to pay promised benefits under the current system, the tax would be reduced to 3.5%, enough to pay for all of the continuing disability and survivors benefits.
- Moreover, as discussed further below, at standard, long term market investment returns, the accounts would produce substantially more in benefits for working people across the board than Social Security now promises, let alone what it can pay. This is the only reform proposal that achieves that result.
- The reform also achieves **the largest reduction in government debt in world history**, by eliminating the unfunded liability of Social Security, almost three times the current reported national debt.
- The reform would also greatly increase and broaden the ownership of wealth and capital through the accounts. All workers would participate in our nation's economy as both capitalists and laborers. **Under the Chief Actuary's score, workers would accumulate \$7 trillion in today's dollars in their accounts by 2020. Wealth ownership throughout the nation would become much more equal, and the concentration of wealth would be greatly reduced.** This is also discussed further below.
- With the above transition financing, Social Security achieves permanent and growing surplus by 2029 under the Chief Actuary's score. Before that time an average of about \$52 billion in surplus Social Security trust funds bonds are sold each year for 24 years, for a total of \$1.25 trillion, all in today's dollars.
- Even with the sale of the surplus trust fund bonds, the trust fund never falls below \$1.38 trillion in today's dollars, or 145% of one year's expenditures, with the official standard of solvency being 100%. After 2029, the trust fund grows permanently, reaching 12.5 times one year's expenditures by the end of the projection period, or about \$6.3 trillion in today's dollars, far too much.
- Within 15 years after 2029, the reform produces sufficient surpluses to pay off all the bonds sold to the public during the early years of the reform. So this surplus completely **eliminates the Federal debt sold to the public in the earlier years of the reform, leaving the net impact of the reform on debt sold to the public at zero.** Indeed, as mentioned above, the reform goes on to completely eliminate Social Security's current unfunded liability of \$10.5 trillion, close to three times the reported national debt.

Analysis of Retirement Benefits Under the Reform Plan

In the IPI study, I reviewed how the reform plan would affect retirement benefits for three hypothetical family/worker combinations.⁴ This is not a comprehensive analysis of how workers would fare under the reform plan. But the compelling results strongly indicate the great gains that would result for workers across the board.

First, take the case of an average income worker age 40 in 2003 earning \$35,000 that year. He entered the work force at age 23 earning \$17,677 per year then, and earns only the average annual salary increase each year. Suppose he was able to exercise the personal account option in the proposal from the start of his career. The payment into his account for the year, at age 40, would be 10% of the first \$10,000 in wages, and 5% of everything above that, for a total of \$2,250.

Assume he invests each year in a diversified portfolio of half stocks and half bonds and earns standard market investment returns. The long term real rate of return on corporate bonds is around 3.5% and for corporate stocks 7% to 7.5% and more.⁵ The comprehensive work by William Shipman on an administrative framework for personal accounts indicates that the administrative costs for such a system would be less than 25 basis points.⁶ Consequently, we may assume that a portfolio of half stocks and half bonds would yield a net annual real return of about 5% over a worker's career, at standard market investment returns.

With such returns, the worker would reach retirement with a total accumulated trust fund of \$334,095, in today's dollars after adjusting for inflation. That fund would be enough to pay an annual annuity about 70% more than what Social Security promises but cannot pay, \$2,653 per month compared to \$1,567. With a higher percentage invested in stocks, the account would pay even more. If the account were invested two thirds in stocks and one third in bonds, at standard market investment returns the worker would reach retirement with an account of \$417,815. That fund would pay \$3,317 per month, just over twice what Social Security promises but cannot pay. With the account invested entirely in stocks and earning standard market investment returns, the worker would retire with a fund of \$576,761, paying him \$5,186 per month, again all in today's dollars. This would be well over three times what Social Security promises, but cannot pay.

Now take the example of an average income two earner couple, each 40 years old in 2003. The husband earned an income of \$40,000 that year, and the wife earned an income of \$30,000, which is consistent with U.S. Census Bureau data regarding the average income of two earner married couples. They again each entered the work force at age 23, with the husband earning \$20,202 that year and the wife earning \$15,152. They also each earn only the average salary increase each year. Suppose again as well

⁴ Ferrara, A Progressive Proposal for Social Security Personal Accounts, pp. 13-14.

⁵ Ibbotson Associates, *Stocks, Bonds, Bills and Inflation 2003 Yearbook, Market Results for 1926-2002* (Chicago, 2003); Peter Ferrara and Michael Tanner, *A New Deal for Social Security*, (Washington, DC: Cato Institute, 1998), pp. 72-73.

⁶ William G. Shipman, Administrative Challenges Facing A Market-Based Social Security System, CarriageOaks Partners, 1999; Ferrara and Tanner, pp. 88-89.

that they exercised the personal account option described above from the start of their careers.

At standard market investment returns, with a diversified portfolio invested half in bonds and half in stocks, the couple would reach retirement with a total fund of \$668,178, again in today's dollars after adjusting for inflation. That fund would be able to pay them about 60% more than what Social Security promises but cannot pay, \$4,987 per month compared to \$3,133. Remember this results from the contributions to the accounts of only 10% of the first \$10,000 in wages and 5% of everything above that, compared with about 10 percentage points of the Social Security tax going to Social Security retirement benefits.

Moreover, with a higher percentage invested in stocks, again the account would pay more. With the account invested two-thirds in stocks and one third in bonds, the couple would reach retirement with \$835,506. That would pay monthly benefits of \$6,236 in today's dollars, again about twice what Social Security promises but cannot pay. With the account invested entirely in stocks, then at standard returns the couple would reach retirement with a fund of over \$1 million (\$1,153,188) in today's dollars. That fund would finance a monthly benefit of \$9,840, again more than three times what Social Security promises but cannot pay.

Low income workers would receive similar gains under our progressive proposal, even though the Social Security benefit formula is skewed to favor lower income workers. Take the example of a worker age 40 in 2003 who earned only \$20,000 that year. Assume he entered the work force at age 23 earning \$10,101 that year. He also earns only average wage increases each year, which leaves him in the same position relative to other workers each year as a worker earning \$20,000 this year. Assume again that he is able to exercise our proposed personal account option from the start of his career.

At standard market investment returns, with a diversified portfolio half in bonds and half in stocks, he would reach retirement with a total fund of \$223,282, in today's dollars. That fund would be able to pay him 64% more than Social Security promises but cannot pay, \$1,773 per month compared to \$1,083. With the account invested two thirds in stocks and one third in bonds, the worker would reach retirement with an account of \$279,607. That fund would pay him \$2,220 per month in today's dollars, again over twice what Social Security promises but cannot pay. With the account completely invested in stocks and earning standard market returns, the worker would reach retirement with a fund of \$386,542 in today's dollars. That fund would again pay him over three times what Social Security promises but cannot pay, \$3476 per month compared to \$1013.

Moreover, such a career low income worker would usually not be entering the work force at age 23, after college. Suppose we assume the worker enters the work force at age 19 earning \$8,600 that year. With the additional funds from four years of early work at ages 19-22, and a portfolio of half bonds and half stocks earning standard returns, the worker would reach retirement with a trust fund of \$271,505 in today's dollars. That fund would pay the worker 84% more than Social Security promises but cannot pay, \$2156 per month compared to \$1172.

With the account invested two-thirds in stocks and one third in bonds, the worker would reach retirement with an accumulated fund of \$350,498. That would pay him \$2,783 per month in today's dollars, again over twice what Social Security promises but cannot pay. A fund invested entirely in stocks starting at age 19 would accumulate for this lifetime low income worker to one half million by retirement (\$500,471), which would pay him close to 4 times what Social Security promises but cannot pay.

We can safely conclude from this analysis that workers across the board will receive substantially higher retirement benefits through the personal accounts than Social Security promises them under current law, let alone what Social Security will actually be able to pay in the future. This is especially so given the broad margins of gain for low and moderate income workers in these examples. The vast majority of family and worker histories would fall within the parameters of these examples, or would involve above average income workers that would clearly gain by broad margins as well.

Why this enormous gulf between what the personal accounts can pay and what Social Security can pay? The personal accounts operate as a fully funded system. The money paid in is saved and invested in new capital investments. These capital investments actually increase production, and the value of this production increase is returned to investors in the form of a rate of return or interest payment on their investments. Over the course of a lifetime, this return would accumulate to large sums, which would then be used to finance benefits in retirement.

But Social Security operates primarily on a pay-as-you-go basis, where the money paid in today is not saved and invested but is mostly immediately paid out to finance current benefits. The future benefits of today's workers are not to be paid by their savings and investment, but by the future taxes to be paid by future workers. Such a system adds nothing to production. It is a mere redistribution system, transferring funds from one segment of the population to another. This means that workers under such a system lose the full amount of the increased production and associated returns they would get if their money was invested in private, productive assets through a fully funded system. The payroll tax financed redistribution system can pay some effective return as revenues grow over time due to increased wages and population growth, enabling the system to pay more to retirees than just what they paid in. But this effective return, which is still obtained by a tax redistribution from others rather than increased production, will never be anywhere near as great as the full returns produced by capital investment.⁷

Conclusions Regarding Progressivity

Based on this background, we can conclude as well that **the Progressive Personal Retirement Account Plan would provide far more benefits and gains for low and moderate income workers, and ultimately be far more progressive, than**

⁷ For further discussion, see Peter J. Ferrara, Social Security Rates of Return for Today's Young Workers (Wash. D.C.: National Chamber Foundation, 1986), pp. 8-11; Peter J. Ferrara and Michael Tanner, A New Deal for Social Security (Wash.D.C.: Cato Institute, 1998), Chapt. 4

either Option 2 offered by the 2001 Social Security reform commission, or by the Diamond Orszag plan. The reasons for this are discussed below.

First, the analysis above indicates that the design of the personal account option in the Progressive Personal Retirement Account plan roughly mirrors the progressivity of Social Security. In our examples above, workers seemed to enjoy roughly the same equivalent net gain over Social Security given the same investment portfolios. For example, with a personal account investment portfolio of half stocks and half bonds, the average income worker would gain about 70%, the higher income two average earner family would gain 60%, and the low income worker would gain 64%. With a more realistic assumption that lifetime low income workers end formal education sooner and start work earlier in life, the net gain for this worker was 84%. So workers with investment portfolios invested half in stock and half in bonds seem to gain roughly two thirds from the account option, and perhaps somewhat more for lower income workers.

Similarly, for portfolios invested two thirds in stocks and one third in bonds, workers in these examples seemed to gain across the board about twice as much as Social Security promises but cannot pay. Higher income workers would enjoy about the same margins of net gain from the same investment portfolios.

This conclusion regarding roughly equivalent net gains would seem to apply to the vast majority of workers, if not all workers. Given the complexity of Social Security and widely varying possible income and family combinations, it may be possible to find some cases where workers and their families may not gain as much as the norm. But all workers should gain substantially in any event.

Moreover, there are ways to make the reform plan more progressive. For example, former Senator Bob Kerrey (D-NE) proposed a Kidsave plan, where the government would deposit \$1,000 into a personal account at birth for each child. This could be added to the Progressive Retirement Account plan, progressively providing a higher relative net gain for lower income workers than higher income workers.

Secondly, the Progressive Personal Retirement Account plan would sharply increase future retirement benefits for low and moderate income workers. The analysis above indicates that through the personal accounts, at standard long term investment returns, these workers would be able to gain an increase in retirement benefits over what Social Security promises, let alone what it can pay, in the range of two thirds more to twice as much, or even more.

As a result, the large accounts in the Progressive Personal Retirement Account Plan would pay much higher benefits to workers in the future than the Diamond Orszag plan, or Option 2 of the 2001 reform commission, with its much smaller accounts. On this basis, that plan is more progressive than either Diamond-Orszag or the reform commission's option 2.

Thirdly, the Progressive Personal Retirement Account plan would pay far higher, market based rates of return for workers across the board than Social Security now offers. For most workers today, even if all of Social Security's promised benefits were somehow paid, the real rate of return paid by the program on the huge taxes paid by workers and their employers over their careers would be 1% to 1.5% or less. For many it would be zero or even negative.⁸ By contrast, as discussed above, the long term real return on stocks is 7% to 7.5% and on corporate bonds 3% to 3.5%. The large accounts in the Progressive Personal Retirement Account plan would consequently sharply raise rates of return for workers across the board. As a result, the plan would sharply improve both benefit adequacy, as discussed above, and equity, providing all workers with higher, market based returns.

Indeed, the Progressive Personal Retirement Account plan would provide workers across the board with higher, more market based returns than either the Diamond-Orszag plan, or the much smaller accounts proposed in Option 2 of the 2001 reform commission. On this basis as well, the Progressive Personal Retirement Account plan is more progressive than either of these two alternatives.

Fourthly, under the Progressive Personal Retirement Account plan, low and moderate income workers would gain much greater accumulations of personal wealth than under Social Security. As discussed in our examples above, even a career low income worker would accumulate by retirement close to \$300,000 in today's dollars, and more, in the large personal accounts provided under the reform plan. A lifetime low income worker who starts work at age 19 and invests two thirds in stocks and one third in bonds would accumulate at standard market investment returns about \$350,000 in today's dollars by retirement. The official score of the reform plan by the Chief Actuary of Social Security concluded that just 15 years after the reform plan is adopted, workers would have accumulated \$7 trillion in their own personal accounts.

Moreover, under the Progressive Personal Retirement Account plan, low and moderate income workers would gain much greater accumulations of personal wealth than under either the Diamond-Orszag plan (which does nothing to increase the personal wealth of working people), or the much smaller accounts proposed in Option 2 of the 2001 reform commission. The Progressive Personal Retirement Account plan is consequently more progressive than either of these 2 alternatives on these grounds as well.

Fifthly, the much larger accumulations of personal wealth by low and moderate income workers under the Progressive Personal Retirement Account plan would greatly broaden wealth ownership in our nation, and sharply reduce the concentration of wealth. A study by Harvard Professor Martin Feldstein indicates that

⁸ Ferrara and Tanner, *A New Deal for Social Security*, Chapter 4; William Beach and Gareth Davis, Social Security's Rate of Return, Report of the Heritage Foundation Center for Data Analysis, , no. 98-01, January 15, 1998; Peter J. Ferrara, Social Security Rates of Return for Today's Young Workers, National Chamber Foundation, Washington, DC: 1986; Peter Ferrara and John Lott, "Social Security's Rates of Return for Today's Young Workers", in Peter Ferrara, ed., *Social Security: Prospects for Real Reform*, (Washington, DC: Cato Institute, 1983), pp. 13-36.

the large personal accounts in the Progressive Personal Retirement Account plan could reduce the total concentration of wealth by as much as one half.⁹ **The Progressive Personal Retirement Account plan is consequently more progressive on these grounds than either the Diamond-Orszag plan (which again does nothing to increase the personal wealth of working people), or the much smaller accounts proposed in Option 2 of the 2001 reform commission.**

Sixthly, the Progressive Personal Retirement Account plan addresses the problem of those with lower life expectancies, who tend to be those with lower incomes, suffering lower returns and lifetime benefits as a result. Under the current Social Security system those with lower life expectancies live fewer years in retirement to collect benefits, and so suffer lower returns and lifetime benefits as a result. But with the large personal accounts of the Progressive Personal Retirement Account plan, workers who die before retirement would not lose everything they had paid into the system over the years. They would be able to leave the account funds they had accumulated to their children or other heirs. After retirement, workers would only have to buy an annuity paying what Social Security promises under current law, and could leave all remaining funds again to children or other heirs, as they choose. Moreover, under the plan, groups that suffer lower life expectancies, such as African Americans, could buy their annuities through social organizations such as the NAACP that would reflect the lower life expectancies of the group. These workers would consequently get higher benefits through those annuities, reflecting the fewer years of retirement they would collect benefits on average.

Neither the Diamond-Orszag plan nor Option 2 of the 2001 reform commission would do as much to eliminate this problem. The Progressive Personal Retirement Account plan is consequently more progressive than these alternatives on these grounds as well.

Would the general revenues used to finance the transition to the personal accounts in the Progressive Personal Retirement Account plan undermine these conclusions? About half of these revenues would come from the corporate revenue feedback discussed above. These are new revenues generated by the reform plan itself that would not exist without the plan. These additional corporate revenues would not burden low and moderate income people and so would not counter any of the benefits of the reform plan for those workers, or undermine the above progressive features of the reform plan.

The rest of the general revenues would come from restraining the growth of other Federal spending. This would be a modest restraint equivalent to the budget savings from the long term baseline achieved during the Clinton years. To the extent that results in eliminating wasteful or counterproductive spending, that would be a net gain to society. This consequently would also not burden low and moderate income people or undermine the above progressive features.

⁹ Martin Feldstein, "Social Security and the Distribution of Wealth," *Journal of the American Statistical Association*, (December 1976): 90-3.

Moreover, there is plenty of scope for restraining Federal spending where that would not adversely affect low and moderate income people or the progressivity of the reform. Cutting back on corporate welfare, unneeded military bases, subsidies for large agribusinesses, and other areas would probably benefit low and moderate income people and enhance progressivity. Reductions in government programs resulting from reforms that reduce dependency also should be seen as enhancing rather than reducing progressivity.

The CHAIRMAN. Peter, thank you.
Now let me turn to Dr. Brown.

**STATEMENT OF JEFF BROWN, Ph.D., UNIVERSITY OF ILLINOIS
AT URBANA-CHAMPAIGN, CHAMPAIGN, IL**

Mr. BROWN. Chairman Craig, Members of the Committee, I thank you for the opportunity to appear before you today.

I would like to begin by summarizing quickly the three main points of my testimony. First, as we heard from Comptroller General Walker this morning, Social Security's poor long-term fiscal health virtually requires that the system be reformed in some manner. Virtually any proposal to restore fiscal sustainability is going to have an effect on the distribution of costs and benefits across the population.

Second, any reform, whether it includes personal accounts or whether it relies solely on tax increases or changes to benefits can be structured to be less progressive, equally progressive, or more progressive than the current system. An important implication of this is that it is possible to design a system that includes personal accounts which is actually more progressive than the system we have today.

Third, Model 2 of the President's Commission to Strengthen Social Security is a specific example of a plan that can restore fiscal sustainability and still provide a strong safety net for low-income individuals and families.

As we heard earlier today, ever since Social Security's inception, policymakers have had to balance sometimes competing goals. Two of these goals which are quite relevant for today are, first, the desire to reduce poverty among low-income elderly, and second, is the desire to make Social Security fair for all participants. Social Security is not and was never designed to be a welfare program. It was designed to provide all participants with benefits that increase as their lifetime contributions increase.

Meeting multiple objectives with a single program is always difficult and it is made all the more so when the resources available to finance the system are insufficient. Indeed, it is actually somewhat meaningless to talk about progressivity without first discussing how the system will be brought back into long-term fiscal balance. Given the well-known fact that Social Security faces these long-run deficits, it is both economically and mathematically obvious that something must change. Either we need more resources flowing into the system or we must decrease expenditures from it. The GAO testimony this morning underscores a very important point, which is that it is possible to design both a sustainable and a redistributive Social Security system that includes personal accounts.

Indeed, the President's Commission made a very conscious effort to do this. There were several features of that plan that I believe are worth highlighting. The first is that the personal accounts in Model 2 are themselves progressive. Low income workers could expect to benefit the most because they were able to contribute a higher fraction of their earnings. Also, within the defined benefit portion of the reformed plan, benefits for low-wage workers were actually increased in order to provide a specific anti-poverty protec-

tion. It is also the case that Model 2 was designed to increase the benefit that was paid to widows and widowers upon the death of a spouse, and in addition, those widows or widowers would be able to receive an inheritance from the account upon the death of their spouse. Both of these features have an important redistributive effect.

The net result, as we saw from the GAO report released today, is that Model 2 actually compares quite favorably to current law in terms of overall progressivity. Yet it does this while achieving fiscal sustainability without relying on a permanent increase in payroll taxes or a permanent infusion of general revenue. There are other reform plans out there that take a very different approach, relying on permanent increases in the tax burden to support a larger program. I simply want to point out that in many of the more expensive reform plans, the incremental dollars are being used to increase the generosity of the program for everyone, not just for low-income workers. So this certainly serves to make the program and more expensive, but it doesn't necessarily do anything to increase progressivity.

In short, just because a reform plan is more expensive does not necessarily mean it is more progressive. Indeed, if Congress wishes to reform Social Security in a way that protects the poor, it still has a choice of whether to do this with a very large expensive system that requires higher tax burdens in the future or whether to do so within a system that actually lives within the existing payroll tax while still providing a strong safety net for low-income individuals. I believe that Model 2 of the President's Commission provides a very useful blueprint on how to do just that, how to design a system that allows Social Security to live within its means over the long term, to be sustainable, and yet still serve the redistributive purpose for which the program was intended.

Thank you.

[The prepared statement of Mr. Brown follows:]

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Statement for the
U.S. Senate Special Committee on Aging

Hearing on:
**Strengthening Social Security: What Can Personal Retirement
Accounts Do For Low-Income Workers?**

June 15, 2004

by

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Chairman Craig, Senator Breaux, and members of the Committee. I am Jeffrey Brown, Assistant Professor of Finance at the University of Illinois College of Business.¹ I thank you for the opportunity to appear before you today to discuss the important issue of Social Security reform and its potential effect on the distribution of costs and benefits within the Social Security program.

I would like to begin by summarizing the three main points of my testimony today.

First, Social Security's poor long-term fiscal health requires that the system be reformed in some manner, and virtually any proposal to restore fiscal sustainability will have an effect on the distribution of taxes and benefits across the population. In other words, reform is inevitable, and therefore, the amount of redistribution will also likely change.

Second, any reform, whether it includes personal accounts or whether it relies solely on tax increases or benefit cuts, can be structured to be more progressive, equally progressive, or less progressive than the current system. An important implication of this fact is that it is possible to create a system of personal accounts within Social Security that leaves the system as progressive, or even more progressive, than it is today.

Third, Model 2 of the President's Commission to Strengthen Social Security is a specific example of a plan that can achieve the twin goals of restoring permanent fiscal sustainability and providing a strong safety net for low-income individuals and families.

¹ I am also a Faculty Research Fellow with the National Bureau of Economic Research. During 2001 and 2002, I served on the staff of the President's Commission to Strengthen Social Security and also served as Senior Economist with the President's Council of Economic Advisers.

Background

Ever since Social Security's inception in the midst of the Great Depression over six decades ago, policymakers have attempted to balance multiple, and sometimes competing, goals for the system. Of these many competing objectives, two stand out as particularly relevant for our conversation today.

1. Adequacy: Social Security was designed to provide a floor of protection for lower income individuals and thus reduce poverty among elderly Americans. This generally entails redistribution from higher to lower earners.
2. Equity: Social Security is not a welfare program. It was designed to provide all participants with benefits that increase as their lifetime contributions increase. In other words, Social Security is meant to provide a "fair deal" for its participants.

While there have been many changes to the Social Security system over the years, including dramatic expansions in coverage and large increases in both taxes and benefits, today we still face the same balancing act between these two objectives of providing a "safety net" for the poorest among us and a "fair deal" for all other participants.

Social Security's Financial Status

Meeting multiple objectives with a single program is always difficult, even more so when the resources to finance the program are insufficient over the long run. Indeed, it is in some sense meaningless to discuss the extent of redistribution within the Social Security program independently from a discussion of how the system will be brought back into long run fiscal balance.

It is well known that the current Social Security system faces quite severe long-run deficits that are expected to begin in 2018 and swell rapidly in the years beyond. Indeed, according to the 2004 Social Security's Trustees' Report, the present value of Social Security's benefit obligations exceeds the present value of the program's revenues by

\$10.4 trillion, a figure that is roughly comparable to the annual Gross Domestic Product of the United States.

To put these numbers into perspective, by the time my infant son reaches his Normal Retirement Age in the year 2070, taxes would have to be 45 percent higher than they are today, or benefits 29 percent lower than they are currently scheduled, in order for the system to self-finance itself during that year.

As such, it is extremely important when comparing reform options to a baseline to ensure that the baseline is itself fiscally sustainable. For example, a baseline that assumes an immediate payroll tax increase equivalent to the size of the 75-year actuarial deficit will be solvent – but unsustainable – because it ignores the large deficits in years 76 and beyond. In cases in which the baseline is itself not sustainable, any analysis must recognize that additional revenue or benefit changes would be required in the future.

Once one recognizes that current payroll tax rates are insufficient to pay for currently scheduled benefits, it becomes obvious that something must change. To be specific, Congress must either increase the revenues flowing into the system, or it must decrease the expenditures from the system.

Each of these approaches can be implemented in many possible ways, but every possible reform option shares the common feature that the way the system is financed or the benefits that individuals receive will be altered. Unless taxes or benefits are changed in a manner that is strictly proportional for everyone, the extent of redistribution of the overall system will change. The important question is how.

Progressivity of the Current Social Security System and Implications for Reform

Up until a few years ago, it was often taken as a matter of faith that Social Security was progressive, meaning that the system transfers resources from higher to lower income individuals. This faith was based on the fact that the Social Security benefit formula is

designed to replace a higher fraction of pre-retirement earnings for low earners than for high earners.

Over the past five years, however, several academic studies were independently and nearly simultaneously conducted that called into question the extent to which the current system effectively redistributed income.² Using different data sets, different methodologies, and even different definitions of progressivity, multiple research teams all came to strikingly similar conclusions: namely, that there is much less redistribution in the current system than previously assumed.

There are several reasons for these findings. They include:

1. Higher income individuals live longer, on average, than lower income individuals. Therefore, because Social Security is paid as a life-contingent annuity³, higher income individuals will, on average, receive a higher level of lifetime benefits than will lower income individuals.
2. Social Security's spousal benefits are based on the earnings of the primary worker. Spouses of high earners therefore receive larger spousal benefits regardless of how much they may have contributed to the program. Because the spouses of high earners also tend to live longer than the spouses of low earners, progressivity is further reduced.
3. Much of the apparent redistribution is from higher income to lower income individuals *within the same household*. In other words, many low-income individuals are married to high-income individuals. Income transfers to these

² Alan Gustman and Thomas Steinmeier, "How Effective Is Redistribution under the Social Security Benefit Formula?" *Journal of Public Economics* 82, no. 1 (October, 2001): 1–28; Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," *National Bureau of Economic Research*, March 2000; Jeffrey Liebman, "Redistribution in the Current U.S. Social Security System," in *Distributional Aspects of Investment-based Social Security Reform*, Liebman and Feldstein.

³ In the case of married individuals, the Social Security annuity can be viewed as a "joint and survivor" annuity because the spousal benefit features continues to pay the surviving spouse. In addition, in special cases, Social Security will provide income to dependent children.

individuals look like redistribution when examined on an individual basis, but not when examined on a household basis.

4. Some workers with low lifetime earnings are really high-income workers who voluntarily chose to exit the formal labor force. Often, these individuals are able to do this precisely because they are married to other high-income individuals. When we count the *potential* earnings of these workers, the current Social Security program's progressivity is further reduced.

One study concludes that only 2.5 percent of total benefits paid out by Social Security are redistributed across income groups.⁴ A second study, which finds income-related transfers on the order of 5 to 9 percent of benefits paid, concludes "income-based redistribution in the current Social security is fairly modest compared to the total benefits paid."⁵ A third study finds that by some measures, Social Security may even be regressive on a lifetime basis.⁶

Even though these studies focused on the existing Social Security system, the findings are quite relevant to the reform debate for two reasons. First, they suggest that there is not as high a degree of household lifetime income redistribution in the current system as many people believe. This is important because the existing system is often used as a benchmark against which to compare other reform options. As one of the studies states: "adoption of a Social Security scheme with individual accounts designed to be neutral with regard to redistribution would make much less difference to the distribution of Social Security benefits and taxes among families with different earnings capacities than is commonly believed."

⁴ Alan Gustman and Thomas Steinmeier, "How Effective Is Redistribution under the Social Security Benefit Formula?" *Journal of Public Economics* 82, no. 1 (October, 2001): 1–28.

⁵ Jeffrey Liebman, "Redistribution in the Current U.S. Social Security System," in Martin Feldstein and Jeffrey Liebman, eds, *Distributional Aspects of Investment-based Social Security Reform*.

⁶ Julia Lynn Coronado, Don Fullerton, and Thomas Glass, "The Progressivity of Social Security," *National Bureau of Economic Research*, March 2000

Second, these studies underscore the importance of analyzing the distributional implications of various reform options from a lifetime, household perspective. It is not sufficient to simply compare a single hypothetical worker at a single point in time under alternative reform plans. To fully understand the distributional implications, one must consider how family structure, mortality-earnings correlations, and other related factors interact with the specific provisions of any reform plan.

Analyses of Social Security reform proposals using microsimulation models, such as that released today by the GAO, have the potential to present a much richer view of both the current Social Security program and alternatives designed to restore it to sustainable solvency. In addition to the GAO, both the Social Security Administration and the Congressional Budget Office now have micro-simulation models that are capable of producing distributional analyses of reform proposals. As such, each of these organizations is now in a position to make valuable contributions to the study and design of Social Security reform options.

Social Security Reform and Progressivity: The Case of PCSSS Model 2

The GAO report underscores a very basic but extremely important point about Social Security reform and progressivity: it is possible to design a fiscally sustainable and redistributive Social Security system that includes personal accounts. Indeed, properly structured, the accounts themselves can be used to increase the degree of progressivity.

This is an important point because it is sometimes assumed that a shift away from the current, pay-as-you-go defined benefit system to a sustainable system that includes personal accounts will somehow hurt the poor. More careful analysis shows that such an assumption is simply false.

Indeed, the President's Commission made a very conscious effort to provide strong protections for lower income workers when designing Model 2. There are several features worth highlighting:

- The personal accounts in Model 2 are themselves progressive, allowing relatively larger contributions by workers with lower earnings. While all personal account participants would expect to benefit from holding accounts under Model 2, lower earning workers would expect to benefit the most because they are able to contribute a higher fraction of their earnings to the account.⁷
- Within the defined benefit portion of Model 2, benefits for low-wage workers would be increased to provide protection against poverty at retirement. Specifically, benefits for minimum wage workers with at least 30 years of labor force attachment would be increased to 120 percent of the poverty line. This is a form of anti-poverty protection that does not exist today, and can mean a significant benefit increase for workers who qualify.
- In fact, the inflation adjusted benefit expected by a low-wage worker in 2052 (the year in which the 1985 birth cohort reaches the Normal Retirement Age) would be approximately 44 percent higher than the benefit received by today's retiree with a low-wage work history.⁸
- Model 2 also increases the benefit paid to low income widows or widowers upon the death of their spouse. Specifically, all aged surviving spouses would receive 75 percent of the benefit that would be received by the couple if both were still alive.⁹

⁷ The offset arrangement in Model 2 uses a 2% offset interest rate, which is lower than the 3% Trust Fund interest rate assumed by OACT. Therefore, an individual participating in the personal account option will have a higher expected benefit than a person who chooses not to participate, even if they invest in a very conservative portfolio. As a result, lower income individuals benefit from the fact that they are able to redirect a larger fraction of their payroll taxes into the account.

⁸ According to the January 31, 2002 OACT Memo "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security," the expected benefit for a scaled low earner in 2052 is \$1,032. In 2004, the benefit for a scaled low earner in 2004 is \$719.

⁹ This benefit provision is limited to what the survivor would have received as a retired worker beneficiary with a PIA equal to the average PIA of all retired worker beneficiaries in the year prior to becoming eligible for this option. For more details, see the January 31, 2002 OACT Memo "Estimates of Financial Effects for Three Models Developed by the President's Commission to Strengthen Social Security" page 6.

- In addition to this benefit enhancement, surviving spouses would also inherit the remaining account balance. Because low-income workers have, on average, higher mortality rates than higher income workers, this inheritability feature may be quite important. Together, these provisions provide substantial protections to low-income widows and widowers.

The result of these features is that Model 2 compares quite favorably to current law in terms of overall progressivity.

The Interaction of Redistribution and Overall Program Resources

One of the most important features of PCSSS Model 2 is that it achieves permanent fiscal sustainability without relying on a permanent increase in payroll taxes or a permanent infusion of general revenue. Importantly, the plan also helps to keep Social Security a “fair deal” for participants by allowing them to invest part of their payroll taxes in personal accounts. The ability to voluntarily redirect part of one’s payroll taxes into personal accounts provides workers with a tangible benefit over which they have ownership and control.

Some other reform plans take a very different approach, relying on permanent increases in the tax burden to support a higher level of Social Security benefits. When evaluating these alternative proposals that rely heavily on increased taxation, it is important to ask how that additional money will be spent. If a disproportionate share of those additional dollars is concentrated at the low end of the lifetime household income distribution, then such an approach would increase the progressivity of the system. But in fact, in many of the more expensive reform plans the incremental dollars are being used to increase the generosity of the defined benefit across the entire income distribution. This serves to make the program more expensive, but does very little to help low-income families.

In short, just because a reform plan is more expensive, it is not necessarily more progressive. In essence, if Congress wishes to have a reformed Social Security system that protects the poor, it still has the choice of whether to do so with a very large and

expensive system, which would require higher taxes or general revenue transfers to pay higher benefits to high income individuals, or to do so with a smaller system that can, over the long-run, live within the confines of the existing payroll tax schedule while still providing a strong safety net for the lowest income households.

Summary

The Social Security system is an integral part of the retirement landscape in the United States. However, as a result of demographic changes that have rendered the current pay-as-you-go system unsustainable, reform of the system is not only desirable, it is inevitable.

Reforming the system to make it fiscally sustainable requires changes to the tax and benefit structure, and thus changes to the progressivity of the system. By carefully designing a system to target benefits to those households with the lowest lifetime earnings, progressivity can be enhanced as part of any reform effort.

The members of the President's Commission to Strengthen Social Security were very much aware of the redistributive role of Social Security and in Model 2 they designed a plan that restores long term fiscal sustainability while strengthening protections for lowest income households. These protections are carefully targeted to low income workers and spouses, and therefore are able to provide a strong safety net without relying on large and permanent increases in taxation. As such, Model 2 provides a very useful blueprint for how Congress can reform Social Security so that the program lives within its means, while still serving the important redistributive purpose for which the program was intended.

Thank you for the opportunity to speak with you today.

The CHAIRMAN. Jeff, thank you very much.
Now let us turn to Jeff Lemieux of Centrists.Org. Welcome to the committee.

**STATEMENT OF JEFF LEMIEUX, CENTRISTS.ORG,
WASHINGTON, DC**

Mr. LEMIEUX. Thank you, senator. Thank you, Senator Kohl as well.

We view our role in this particular debate as providing data to help evaluate the various different types of proposals rather than pitching any one particular proposal or explaining its merits. We also have tried to foster some bipartisanship on this issue, which has been very hard. There is one particularly good example of bipartisanship in the House. Representatives Kolbe and Stenholm have a new bipartisan bill that we have analyzed, and we also had an event recently where Representative Harold Ford discussed with Senator Lindsey Graham some approaches and some possible areas for common ground. I thought that was very helpful. In addition, as has already been mentioned, the economists Peter Orszag and Peter Diamond have put forward a proposal that is very responsible in its financing.

Unfortunately, these constructive approaches and efforts seem to be the exception rather than the rule. Most of the political discussion on Social Security is very shrill and simplistic, and as a result, the most popular proposal is probably the do-nothing option. At the other extreme are these very large account proposals which have been characterized as free-lunch plans. If we pour lots of money into Social Security accounts, they will, in fact, provide a lot of money for people, but financing them is very difficult. I am particularly concerned that legislators might not have a clear picture of either the budgetary or the distributional consequences of some of these more extreme proposals.

I have a chart packet that was included with the testimony. All of the charts in the testimony are also in the written statement, but if you have this packet, I will go through a couple of the charts as examples. The first chart is called "Four Big Entitlements", and as you can see at the bottom is Social Security, which doesn't look bad by comparison with Medicare and with another entitlement that is often not mentioned in the debate, which is interest on the National debt. If we continue to accumulate deficits and debt and interest rates go back up, then after 2030 we will have to pay even more in interest, conceivably, than Medicare or Social Security.

The second chart, Figure 2, just goes through Social Security costs and revenues. The blue line shows that we expect Social Security benefit costs to grow from about 4.2 or 4.3 percent of GDP up to about 6.3 percent of GDP and then remain flat thereafter once the baby-boomers have retired, while dedicated tax revenues are about 5 percent of GDP and roughly flat. This is the nature of the Social Security financing problem.

Figure three shows the difference between those two lines, revenues and costs. We are currently in a position of surplus where the Social Security revenues raise more than we pay in benefits, but that will switch over to a deficit in about 10 or 15 years and then

become a long-term deficit ranging between one and 2 percent of GDP, which is a substantial amount.

The next figure shows roughly how the Kolbe-Stenholm approach would attempt to solve that deficit problem. It would bring the surplus down to zero immediately, spending money to build private accounts, but reducing the deficit to a much lower rate in the long run.

Chart 4 shows Senator Graham's proposal, which is similar to Kolbe-Stenholm in its effect, and the Ferrara proposal, considering the cost of Social Security where the baseline goes up from a little over 4 percent to over 6 percent. The Graham proposal would increase Social Security costs for the time being and then reduce them in the long run. The Ferrara proposal would increase them by a considerably larger amount, but then also reduce them in the long run. To be fair to Senator Graham, the final version of his proposal is opening a wide variety of financing mechanisms that would help reduce that increase in Social Security costs in the short run.

The Diamond-Orszag plan essentially is the best performing proposal on the metric of how much it costs to implement. Dr. Walker talked about the long-term present value of these plans and how the current law is between four and five trillion. The Ferrara plan is over seven trillion. Some of the other account proposals, like the Graham and the Kolbe-Stenholm plans are in the neighborhood of two to three trillion. The Diamond-Orszag plan is under one trillion. In that sense, it is the best performer. The down side of the Diamond-Orszag plan is that it incorporates a permanent increase in taxation.

Finally, I would like to mention the new Social Security numbers that came out yesterday. These are in Figures 7 and 8 and came out from the Congressional Budget Office. They differ slightly from the numbers that I have been using, which come from the Social Security trustees. CBO sees slightly lower outlays, especially between about 2020 and 2060 and slightly higher revenues after about 2040. They also have some differing economic assumptions; for example they assume higher interest rates on the debt that Social Security—the Treasury debt that Social Security holds and the Government pays Social Security interest on which has the effect of extending the life span of the Social Security fund, but I think most economists discount that measure.

The final chart shows the graphic of the deficit. CBO assumes that it is between one and 1.5 percent of GDP. The trustees are a little higher between 1.5 and 2 percent of GDP.

Finally, Mr. Chairman, just in response to an earlier question, the final figures from Dr. Walker will probably be more authoritative, but raising the tax cap to about 140 or \$150,000 a year probably saves between .2 and .3 percent of GDP. In other words, it would raise Social Security financing by .2 or .3 percent of GDP, depending on whether or not you allow those extra taxes to accrue benefits when people eventually become retirees. So that would help close the gap a little bit, but it wouldn't close the gap completely or anything even close to that.

Thank you.

[The prepared statement of Mr. Lemieux follows:]



Testimony: Comparing Social Security Reform Proposals

Jeff Lemieux

For the Senate Special Committee on Aging
June 15, 2004

Summary: Social Security reforms have the potential to help future generations avoid large tax increases or benefit cuts, and to enable lower-income workers to more easily accumulate savings and wealth. However, the hyper-politization of Social Security has dimmed the prospects for a constructive discussion. To cut through the political noise and cultivate some bipartisanship, we need accessible, unbiased explanations of how reform proposals would impact the budget and affect workers. Like government in general, I believe Social Security should be small but progressive. Legislators should consider Social Security reform proposals that would restrain federal spending while also helping lower-income workers.

Outline:

A Need for Clear, Evenhanded Analysis
Four Criteria for Evaluating Reform Proposals
Budget Impact
Degree of Progressivity
Wealth-Building Potential
Use of Gimmicks or General Revenue Transfers
Comparison of Social Security Trustees' and New CBO Projections

Thank you, Senator Craig and members of the committee, for inviting me. My name is Jeff Lemieux, and I'm the Executive Director of Centrists.Org. Our mission is to help policymakers develop ideas that could achieve lasting bipartisan support on some of the toughest national issues -- health care, budget deficits, social security, and so on.

My comments will focus on how to evaluate Social Security reform proposals. I will refer to several charts and tables, which are also printed in a [supplemental handout](#).

A Need for Clear, Evenhanded Analysis

There are a few glimmers of bipartisanship and responsibility on Social Security reform.

Representatives Jim Kolbe and Charlie Stenholm have a new bipartisan bill, and Democratic Rep. Harold Ford recently expressed conditional interest in Republican Senator Lindsey Graham's reform proposal. Both proposals include moderately sized, progressive personal accounts and attempt to "pre-fund" a portion of Social Security benefits.

Economists Peter Orszag and Peter Diamond have offered a responsible reform proposal that is not based on personal accounts. As a result, their proposal does not require transition financing.

Unfortunately, these constructive proposals are the exception in the Social Security debate. Most of the political discussion takes place at the much lower level of partisan name-calling and opportunism, scare tactics, or unrealistic promises.

Because the debate is so shrill and simplistic, the most popular Social Security proposal is the "do nothing" approach.

At the other extreme is the "free-lunch" privatization idea, which would create very large personal accounts out of current payroll taxes.

I am concerned that legislators might not have a clear picture of either the budgetary or distributional consequences of these more extreme proposals.

Evasive or deceptive proposals imply that tough choices are not needed. Until they are more thoroughly analyzed, these sorts of proposals can seem too good to be true.

Part of the problem is that the issue of Social Security reform is so politically sensitive that "do-nothing" advocates and "free-lunch" proponents sometimes feel justified in exaggerating their claims, or in attempting to create a frame of analysis that obscures the central facts.

A related problem is the hyper-politization of policy analysis in Washington. Even the most bland or technical analysis can become fodder for partisan political propaganda if its implications aren't spelled out very clearly.

The data and comparisons below are mostly cobbled together from technical reports and tables from the Social Security Administration's Office of the Actuary (OACT). OACT's analyses are highly professional, timely, and helpful. However, because they are so technical, they can be prone to misinterpretation or false claims.

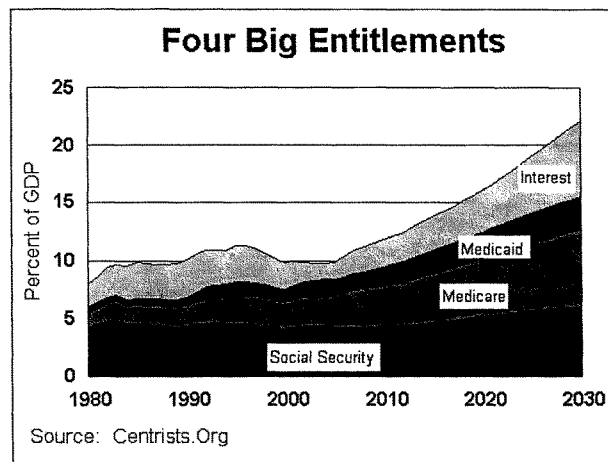
Four Criteria for Evaluating Reform Proposals

Social Security reforms should be evaluated on four criteria, in a descending order of importance:

- (1) impact on the budget,
- (2) degree of progressivity,
- (3) opportunities for wealth creation, and
- (4) the presence or absence of gimmicks.

1. Impact on the Budget. The first reason for reforming Social Security is that its costs would otherwise raise government spending by about 2 percentage points of gross domestic product (GDP). Although Social Security costs are likely to be exceeded by both Medicare spending and interest expenses as the baby boomers retire (presuming the deficits and national debt are permitted to grow on their current trajectory), those extra 2 percentage points of GDP represent an important part of the larger entitlement problem (see Figure 1).

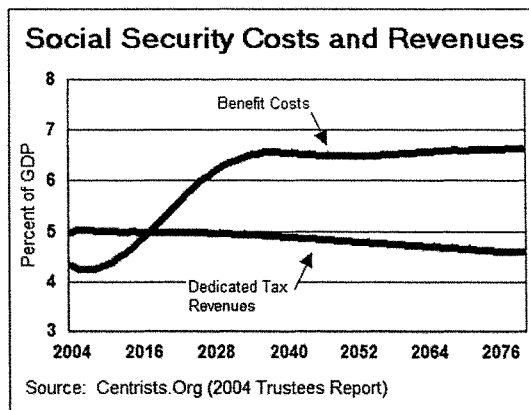
Figure 1.



Another way to think about Social Security's future budget problem is to compare the program's benefit obligations with its dedicated tax revenues (mostly payroll taxes). This measure is not perfect, because it's impossible to really force the federal government to use particular revenues for unique purposes. However, it is a very common and logical approach.

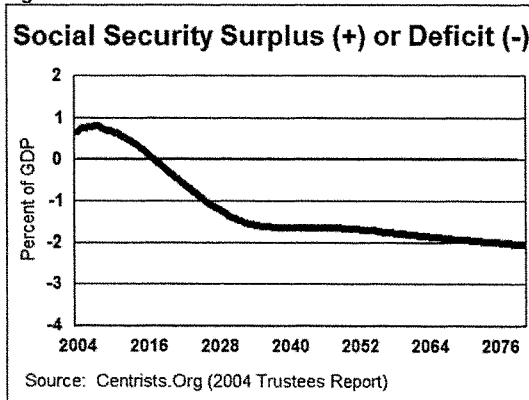
Using long-term projections from the 2004 Social Security Trustees Report, Figure 2 shows that Social Security costs are expected to rise from 4.3 percent of GDP in 2010 to 6.3 percent by 2030. Meanwhile, tax revenues dedicated for Social Security are projected to remain roughly flat at about 5 percent of GDP over the next 30 years.

Figure 2.



The difference between these costs and dedicated revenues is Social Security's effective cash-flow surplus or deficit. Because benefit costs are currently lower than revenues, Social Security is running a surplus. However, Social Security's current surplus is expected to disappear and become a deficit after 2010 as the baby boom generation starts to retire in large numbers. After 2030, the Social Security deficit is projected to be between 1.5 and 2 percent of GDP (see Figure 3).

Figure 3.



By this measure, to fully solve Social Security's budget problem, a reform proposal must close the 1.5 to 2 percent of GDP gap between revenues and costs in the long run, without (1) creating overly high or unmanageable transition costs over the next 20 years, and (2) relying on financing gimmicks or "one-sided bets," such as overly optimistic assumptions about investment returns on personal accounts, unlikely claims about economic gains or increases in national savings, or absolute guarantees that Social Security benefits would never be reduced.

Consider five alternative approaches:

- o The "Do Nothing" Approach
- o The Diamond-Orszag Proposal
- o The Lindsey Graham Proposal
- o The Kolbe-Stenholm Bill in the House
- o A "Free-Lunch" Proposal (The Ferrara Plan)

Table 1 shows the projected costs and revenues of Social Security under each of these five alternatives.

Table 1.
Social Security Costs and Reform Options
(as a percent of GDP)

<i>Selected Years</i>	2010	2020	2030	2040	2050	2060
Baseline Benefit Costs	4.3	5.3	6.3	6.5	6.5	6.5
"Dedicated" Revenues	<u>5.0</u>	<u>5.0</u>	<u>5.0</u>	<u>4.9</u>	<u>4.8</u>	<u>4.7</u>
Gap	-0.7	0.3	1.3	1.6	1.7	1.8
Reform Options:						
Sen. Lindsey Graham	1.1	0.9	0.3	-0.5	-1.3	-2.0
Kolbe-Stenholm	0.6	0.2	-0.2	-0.7	-1.2	-1.5
Peter Ferrara	2.4	2.2	1.3	0.2	-1.2	-2.0
Diamond-Orszag	-0.3	-0.3	-0.5	-0.8	-1.1	-1.5
Misc: Tax Max at \$140k	-0.3	-0.3	-0.3	-0.2	-0.2	-0.2

Source: Centrists.Org

Note: Data from the 2004 Trustees Report and other reports from Social Security's Office of the Actuary.

By maintaining the status quo, the do-nothing approach implies a permanent Social Security deficit of between 1.5 and 2 percent of GDP, and federal deficits that are roughly 2 percentage points of GDP higher than today's.

The other four proposals would successfully close Social Security's funding gap in the long run. However, the Graham proposal includes significant transition costs, which would otherwise burden current taxpayers.

The Kolbe-Stenholm proposal does a better job of limiting and "paying for" its transition costs, although its long-run savings are a little smaller.

The Ferrara proposal contains huge, economically untenable transition costs -- much higher than

most other reform proposals.

The Diamond-Orszag proposal, which mostly uses tax increases to solve Social Security's funding problem, does not have transition costs. The budgetary downside to that proposal, however, is that its tax increases, though gradual, are permanent.

Figure 4 shows the cost of doing nothing vs. the cost of the Graham and Ferrara plans.

Figure 4.

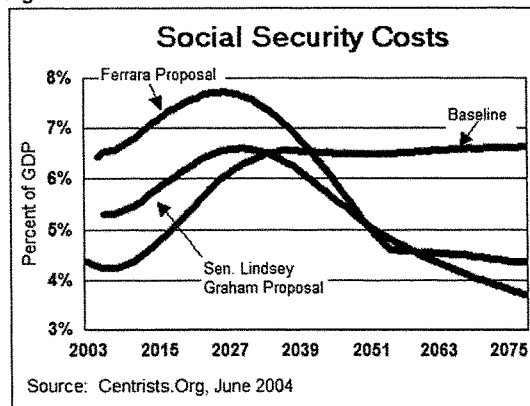


Figure 5 shows the long-term impact of the Kolbe-Stenholm proposal on the Social Security operating deficit.

Figure 5.

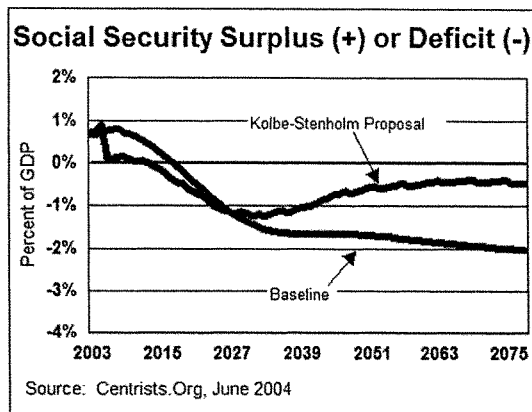
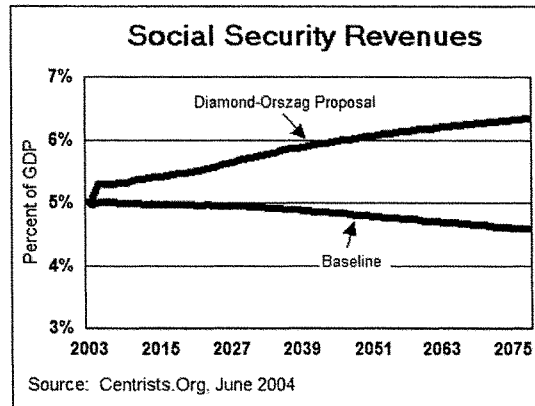


Figure 6 shows the revenue increases included as part of the Diamond-Orszag proposal.

Figure 6.



2. Degree of Progressivity. If it were a private pension system, Social Security benefits would be calculated based on a one-to-one relationship to payroll taxes paid. That is, a worker who paid twice as much in payroll taxes as another worker would receive twice the benefit.

However, Social Security is not a private pension system; it is a public social insurance system. As social insurance, its benefits are generally proportionate to payroll taxes, but not in a one-to-one relationship.

The purpose of these deviations from a strict one-to-one relationship between taxes and benefits is social: to prevent poverty among the elderly and disabled workers, and certain of their family members.

I believe a key criterion for Social Security reform -- and a prerequisite for bipartisanship -- is to maintain or enhance the program's progressivity.

However, there isn't much official data on how the various reform proposals would stack up against the current degree of progressivity in the Social Security system.

I propose that in addition to requiring side-by-side tables on the cost and savings from Social Security proposals, Congress should insist on simple tables that illustrate the distributional consequences -- the degree of progressivity or regressivity -- as well.

For example, Table 2 shows the simulated impact of Senator Graham's proposal on workers who earned various amounts during their pre-retirement years. The Graham plan would be somewhat more progressive than current law, with lower-income workers getting relatively higher benefits, and high-income workers receiving relatively lower benefits.

Table 2.

**Simulation of Sen. Lindsey Graham Social Security
Proposal on Married Workers Retiring at NRA in 2034**
Assuming Normal (60% Stock, 40% Bond) Investment Returns
(all amounts in 2003 dollars)

Average Annual Earnings (each spouse)	Average Annual Earnings (each spouse)	Average Annual Earnings (each spouse)	Annual Earnings Above (each spouse)
\$16,600	\$34,700	\$55,600	\$87,000
Current Law Monthly Benefit Promised (Not Funded)			
860	1,417	1,879	2,294
Proposed Law Defined Benefit			
590	822	1,180	1,505
Benefit from Individual Account (Basic Contribution)			
232	381	417	415
Range of Benefit from Matched Contributions la			
80	6	0	0
414	29	0	0
Range of Proposed Law Benefit (Total)			
902	1,209	1,597	1,920

1,236 1,232 1,597 1,920

Source: Centrists.Org.

Notes: Assumes default investment returns based on 60% stock, 40% "safe" long-term bond return. Based on couples with equal work careers and earnings.

Couples have typical earnings profile (except highest-earning couple assumed to have earnings at or above the taxable maximum in all years). It is important to remember that comparisons with currently promised benefits may be misleading if the government would not be able to fund those promises in the future. Calculations do not include income from unmatched voluntary contributions. NRA = normal retirement age.

1/2 Low range of benefit from matched contribution assumes low-income worker voluntarily saves \$101 per year and receives gov't match of \$150. High range assumes low-income worker voluntarily saves \$801 per year and receives maximum gov't match or \$500.

Table 3 shows a similar distributional comparison of the Graham plan, using data from an alternative source, and for a different year and family structure. Table 3 also includes a hypothetical minimum wage worker, which is especially helpful in illustrating the improvement in progressivity under this plan.

The estimates in Tables 2 and 3 are admittedly sketchy. They were computed based on unpublished data, and cannot be easily replicated. I apologize for that.

However, the results seem reasonable, and further analyses by OACT, the Congressional Budget Office (CBO), or the Congressional Research Service will probably show similar patterns. Hopefully, the official estimating agencies will publish tables like Tables 2 and 3 as a matter of course, so that lawmakers can quickly view the distributional impacts of the various plans.

Table 3.
Simulation of Sen. Lindsey Graham Social Security
Proposal on Single Workers Retiring at Age 62 in 2041
Assuming Normal (60% Stock, 40% Bond) Investment Returns
(all amounts in 2003 dollars)

Minimum Wage Earner	Low Wage Earner	Average Wage Earner	High Wage Earner	Annual Earnings Above
\$10,712	\$16,600	\$34,700	\$55,600	\$87,000
Current Law Monthly Benefit Promised (Not Funded)				
636	774	1,285	1,699	2,052

Proposed Defined Benefit and Basic Individual Account Benefit				
684	723	1,115	1,407	1,655
Range of Benefit from Matched Contributions ^{1a}				
151	151	12	0	0
783	784	64	0	0
Range of Proposed Law Benefit (Total)				
835	874	1,127	1,407	1,655
1,467	1,507	1,179	1,407	1,655

Source: Centrists.Org.

Notes: Assumes default investment returns based on 60% stock, 40% "safe" long-term bond return. Based on single workers with typical earnings profile (except, highest-earning worker assumed to have earnings at or above the taxable maximum in all years, and min. wage worker assumed same wage all years). It is important to remember that comparisons with currently promised benefits may be misleading if the government would not be able to fund those promises in the future. Calculations do not include income from unmatched voluntary contributions.

^{1a} Low range of benefit from matched contribution assumes low-income worker voluntarily saves \$101 per year and receives gov't match of \$150. High range assumes low-income worker voluntarily saves \$801 per year and receives maximum gov't match of \$500.

Although I have no data to show the committee -- not even sketchy estimates like Tables 2 and 3 -- I believe both the Kolbe-Stenholm and Diamond Orszag plans are considerably more progressive than current law.

However, my hunch is that the Ferrara proposal would be slightly less progressive than current law.

3. Opportunities for Wealth Creation. I believe that Social Security reform could be used as a lever to help many lower-income workers find easier ways to save and accumulate a modicum of financial wealth.

Too many Americans approach retirement without sufficient financial assets. Many own a home, but possess few financial assets. Some reach retirement age without assets of any kind, and are therefore completely dependent on Social Security and (possibly) some welfare programs.

Over the last two decades, the availability of generous defined benefit pensions (a fixed pension based on years of service and wages at a given firm) has declined. It is no longer common for workers to stay with one employer for 20 or 30 years and retire with a pension that replaces a decent percentage of their income.

A large percentage of workers now have access to 401k savings programs at work, and many people have established Individual Retirement Accounts (IRAs) or an alphabet soup of other tax-favored savings programs. However, some workers have used these retirement savings programs instead to fund education or housing or consumption expenses, sometimes paying a steep tax penalty as a result.

Sufficient retirement income is a moral and social imperative -- we simply don't want seniors to be desperately poor.

However, asset building is also extremely important. Income support is not enough. In the U.S. capitalist system, wealth allows people to take risks, to launch businesses or educate children. Without some wealth, families can't make the investments necessary to get ahead. With some assets, people can borrow; without assets, it is hard to get that first loan.

Personal accounts that can be held as assets in a family are an important part of Social Security reform. Accounts that are notionally owned by workers, but which are not actually under workers' control and which must be distributed in full when a worker retires do not pass the test of wealth creation.

4. Gimmicks, "Leverage," and Exotic Benefit Guarantees. Proponents of Social Security personal accounts should use reasonable assumptions about the rates of return workers are likely to achieve, and should not promote the accounts as likely to lead to a large increase in national savings and investment.

Riskier investments earn higher returns in the long run precisely because they are risky -- the expected value of a risky investment is higher, but the possible deviations from the expected returns are also greater. Risky private investments offer great opportunities for gains, but can also lose money.

Some proponents of Social Security private accounts insist that because private investments will have a high rate of return, the accounts are essentially "free money," creating national wealth that would not otherwise have been created.

In particular, proponents of large Social Security accounts claim that rates of return on those accounts will be so high that the government can be assured that all workers will be better off, and can guarantee the current Social Security promised level of benefits without risk.

These arguments are largely misplaced. Even if workers decided to make risky investments in their Social Security accounts, there is no reason to believe that Americans' overall tolerance for risk will increase. Investors may simply readjust their outside portfolios toward less risky investments, and overall national rates of return and levels of investment would be about the same.

An economist's maxim is "beware the free lunch," and Social Security calculations that sound too good to be true are usually based on the tenuous assumption that Social Security reform will dramatically increase national savings and investment, and raise the national tolerance for risk. Proponents of Social Security accounts should not depend on such "leverage" in their calculations of the likely impact of reforms.

Social Security reform could spark increases in national savings, if the funding for personal accounts is at least partially "paid for" with tax increases or spending cuts, and if workers believe the funds in their Social Security accounts represent a replacement for benefit cuts and therefore do not adjust their outside levels of savings.

But the vague promise of higher national savings and returns on investment is not sufficient to create elaborate guarantees that all workers will be better off under reform. The government should not be on the hook to compensate workers for investments gone bad, either within or outside the Social Security system. Taxpayers should not be asked to take that risk, and if they did, we could be sure that investors would be less careful -- and possibly even reckless -- with their portfolio

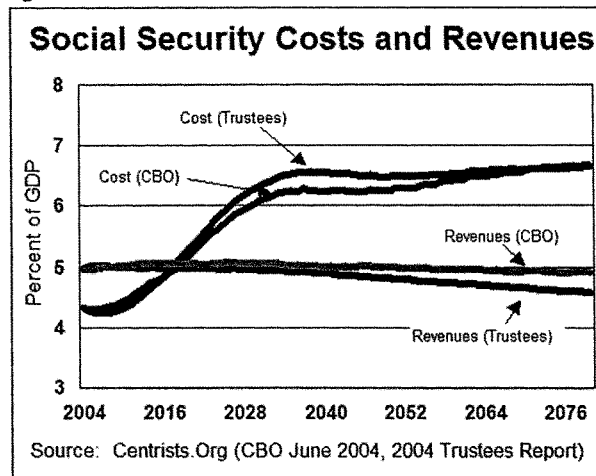
allocations.

A final thought on inflated claims and guarantees: If these sorts of benefit guarantees were funded by the private sector -- which presumably has both the ability and the incentive to price them correctly -- the costs would probably be significantly higher than those indicated in standard actuarial analyses.

Comparison of Social Security Trustees' and New CBO Projections

Yesterday, the Congressional Budget Office (CBO) released a new report on Social Security's long-term outlook. CBO's new cost projections are slightly lower than the Social Security Trustees Report within the 2020 - 2060 period, and CBO's outlook for revenues is slightly higher after 2040 (see Figure 7.)

Figure 7.



However, Figure 7 shows that CBO's new model is really telling us a very similar story: Social Security benefits will jump by about 2 percentage points of GDP over the next 25 years, while revenues stay roughly flat. For policymaking purposes, there is little real difference between CBO's new overall cost and revenue outlook, and that of the Social Security actuaries.

Figure 8 shows how CBO's projection of Social Security's long-term surplus or deficit stacks up against the Social Security actuaries' estimate. The gap between projected benefit costs and revenues is slightly lower in CBO's estimate, but the differences are not very large, and the overall conclusion about Social Security's financial situation shouldn't be changed.

Table 4 (below) details how CBO's projections compare with those of the Trustees in ten-year increments between 2010 and 2060.

Figure 8.

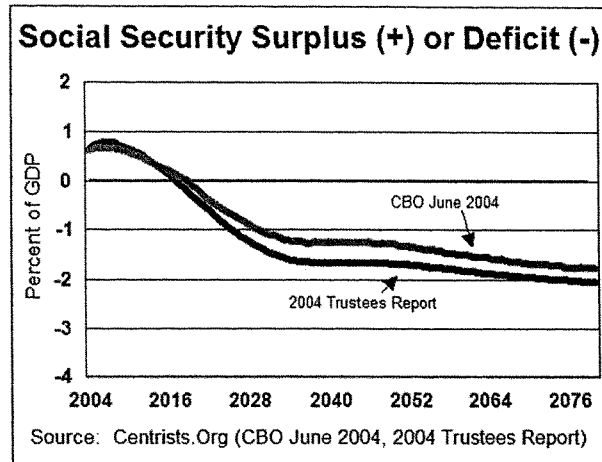


Table 4.
Social Security Costs and Revenues – CBO
vs. Trustees
 (as a percent of GDP)

Selected Years	2010	2020	2030	2040	2050	2060
CBO (June 2004)						
Benefit Costs	4.4	5.2	6.1	6.2	6.3	6.4
"Dedicated" Revenues	<u>5.0</u>	<u>5.1</u>	<u>5.1</u>	<u>5.0</u>	<u>5.0</u>	<u>5.0</u>
Gap	-0.6	0.1	1.0	1.2	1.3	1.5
2004 Trustees Report						
Benefit Costs	4.3	5.3	6.3	6.5	6.5	6.5
"Dedicated" Revenues	<u>5.0</u>	<u>5.0</u>	<u>5.0</u>	<u>4.9</u>	<u>4.8</u>	<u>4.7</u>
Gap	-0.7	0.3	1.3	1.6	1.7	1.8

Source: Centrists.Org

Notes: Data from 2004 Social Security Trustees Report and the Congressional Budget Office (CBO)

"The Outlook for Social Security" (June 2004). Figures may not sum to totals because of rounding.

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References:

Centrists.Org Transcript: Addressing Greenspan's Challenge on Social Security and Savings: Views from an Emerging Generation of Political Leaders
revised 04.02.2004 || Transcript of a discussion on Social Security reform held on March 25, 2004 with Senator Lindsey Graham and Rep. Harold Ford, moderated by Morton Kondracke of *Roll Call*.

Centrists.Org The Kolbe-Stenholm Social Security Reform Plan
revised 02.14.2004 || The new Social Security reform plan proposed by Reps. Jim Kolbe and Charlie Stenholm combines fiscal responsibility with the wealth-building potential of personal Social Security retirement accounts.

Centrists.Org Budgetary Effects of the Diamond-Orszag Social Security Proposal
revised 12.31.2003 || This proposal would resolve Social Security's funding shortfall directly, mostly by raising taxes. The plan is fully "paid-for," without gimmicks or wishful assumptions. The downside is that the tax increases would be permanent, not temporary.

Centrists.Org Unfunded Transition Costs of the Ferrara Social Security Proposal
revised 12.10.2003 || Anti-tax activist Peter Ferrara's Social Security reform plan includes large personal accounts and a guarantee that benefits would not be reduced. What's the catch? The enormous unfunded transition costs.

Centrists.Org A Preliminary Analysis of Sen. Graham's Social Security Proposal
revised 12.14.2003 || The reform proposal introduced by Sen. Lindsey Graham of South Carolina this morning is serious and worthy of bipartisan consideration.

Centrists.Org Raising the Cap on Payroll Taxes Doesn't Solve the Social Security Problem
 11.17.2003 || Raising the cap on annual earnings subject to the payroll tax (\$87,000 in 2003) would simply defer Social Security's cash-flow problem by a few years -- it isn't a permanent solution.

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The CHAIRMAN. Jeff, thank you very much.
Now let us turn to Christian Weller, Center for American Progress. Christian, welcome.

**STATEMENT OF CHRISTIAN WELLER, Ph.D., CENTER FOR
AMERICAN PROGRESS, WASHINGTON, DC**

Dr. WELLER. Thank you very much, Chairman Craig. Thank you very much, Senator Kohl, for inviting me here today to talk about individual accounts and Social Security.

I would like to make the following three points on my testimony today: Social Security is a necessary and increasingly important component to providing retirement income adequacy; second, any expected shortfalls under Social Security can be addressed without radically changing the system; and third, privatization as an alternative to fixing Social Security within the parameters of the system is too risky and too costly, especially for low-income families.

Usually, 80 percent of pre-retirement income is considered adequate for a decent standard of living. A substantial minority of households, typically one-third, fall short of the standard. The shortfalls are especially large for minorities, single women, workers with less education, and lower-wage workers. To make ends meet in retirement, these households will have to curtail their consumption, often severely, and rely on public assistance in retirement. Retirement income adequacy has also worsened for the typical household over the past 2 years.

Underlying this trend are three factors: first, pension coverage has remained low and declined in recent years; second, retirement wealth has become increasing unequally distributed; and third, with the proliferation of defined contribution plans, such as 401(K) plans, risk has shifted onto workers. Against this backdrop, Social Security gains in relative importance. Its coverage is almost universal. Its benefits favor low lifetime earners and has guaranteed lifetime inflation-adjusted benefits.

Part of Social Security's importance also results, as was mentioned before, from its other benefits, in particular disability and survivorship benefits. These benefits are often at stake when Social Security benefits are reduced to pay for privatization, but we have got to keep in mind that Social Security benefits are bare bones. The average replacement ratio in the U.S. is about half of that in Germany or Italy, and the average monthly benefit was about \$850 in 2002, yet Social Security benefits were 80 percent of income for households—retirement income for households in the bottom 40 percent of the income distribution in 2000, meaning that the private sector is still not doing its job to help low-income workers. Yet, Social Security trustees predict a financial shortfall in the long run. It is anticipated that by 2042, Social Security will have exhausted its trust funds and the tax revenue will cover only more than two-thirds of promised benefits. An immediate and permanent increase of the payroll tax by 1.9 percent would allow Social Security to cover all its shortfall.

Social Security expenditures, however, are expected to stabilize around 6.5 percent of GDP in the long run, but payroll taxes will grow as the tax base of the system shrinks at the same time; thus, I would submit, that Social Security's expected shortfalls can be ad-

addressed within the parameters of the system. One example would be the Diamond-Orszag plan, and other examples come from the 1994 and 1996 Advisory Council on Social Security.

Privatization, however, as an alternative is too risky and too costly, and it would require a large transfer from general revenue and large benefit cuts to pay for benefits that workers have already earned. With privatization, insurance is replaced with savings accounts. That is, the risks are privatized. These risks include the risk of misjudging the market and investing and losing assets. Another risk is the possibly of financial markets staying low for long periods of time. Moreover, workers face also the risk that they will exhaust their savings during the retirement and, finally, a risk that we haven't paid enough attention to, in my view, workers face the risk that they are out of work or have low earnings when asset prices are low, so they cannot take full advantage of dollar cost averaging.

Along with the risks, the costs also rise. For one, administrative costs rise particularly for low income workers in small plans. Most estimates put these administrative costs well above 1 percentage point of assets per year. Other costs arise from the loss of security. For instance, workers could purchase lifetime annuities to minimize longevity risks, and they could purchase invest guarantees to reduce market risk. However, the cost of lifetime annuities average about 5 percent of accumulated savings with higher costs for smaller accounts. That means that their benefits are reduced by 15 to 20 percent compared to no costs, and the cost of guaranteed minimum benefits amounts to about 16.1 percent of annual contributions during a 40-year period with a balanced portfolio, according to estimates of Professor Mitchell from the University of Pennsylvania.

Some workers are more likely than others to experience unemployment and low wages during an economic downturn, thus they cannot take full advantage of dollar cost averaging. In recent research that I have done with Professor Wenger from the University of Georgia, we find that this adds costs similar to those associated with annuitization for women and minorities. All of these costs will not be offset with substantially higher rates of return. In particular, Social Security expected shortfalls are based on low growth assumptions, but stock market returns follow economic growth over the long run; hence if the trustees are correct in their assumptions, the real rates of return on the stock market should also fall below historical averages.

Privatization also increases the cost to the Government. We already heard a lot about that. Let me just say that in addition to greater transfers from general revenue into Social Security, privatization would also reduce promised benefits.

I will end my remarks here, seeing that the light is on. Thank you very much.

[The prepared statement of Mr. Weller follows:]

**Testimony before the U.S. Senate Special Committee on Aging on “Strengthening
Social Security: What Can Personal Retirement Accounts Do for Low Income
Workers?”**

The Cost of a Free Lunch

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I. Introduction

Good morning. Thank you very much, chairman Craig, ranking member Breaux, and members of the committee for this invitation to speak to you today on the issue of individual accounts and Social Security.

The future of retirement is a story of good and bad news. People are living longer than any generation before them, yet improvements in retirement income security appear elusive. In the private pension sector, lacking pension coverage, insufficient wealth accumulation and growing risks stand in the way of giving the vast majority of household adequate retirement savings. Yet, Social Security offers almost universal coverage, distributes benefits progressively, and offers guaranteed lifetime benefits, i.e. many households enjoy a basic level of retirement income security due to Social Security.

The broadly shared benefits of Social Security need to be kept in mind when considering changes to the system. Specifically, changes to Social Security need to accomplish two things. First, they need to maintain or enhance the level of Social Security benefits for all workers given that Social Security's benefit levels are generally considered a basic benefit. Second, changes to Social Security's financial structure need to protect the level of future benefits since improvements in retirement income security have been rather elusive, despite the fact that workers can expect to spend ever longer periods in retirement.

The replacement of Social Security with individual accounts – privatization – is inconsistent with these goals. Privatization constitutes an erosion of benefits since it exposes individuals to greater risks that can only be partially compensated for by incurring substantial costs. Second, privatization significantly weakens the financial outlook of Social Security, which is reflected in significant reductions of future benefits or higher burdens on tax payers than would otherwise be the case.

Reforming Social Security within its parameters is not impossible, but it does require some hard choices. In particular, it requires choosing from a range of options that includes a willingness to acknowledge that improving Social Security's long-term financial outlook may necessitate either tax increases or benefit cuts or other revenue raising options. But these changes, if necessary, are small in comparison to the costs associated with privatization. Thus, improving Social Security's finances within its existing parameters would maintain current and future benefit levels, without skyrocketing costs for beneficiaries and tax payers.

II. Retirement Income Adequacy

Calculations of retirement income adequacy are a critical measure of the future state of retirement security. Calculations of retirement income adequacy relate retirement consumption to pre-retirement consumption in three possible ways. First, a household may be considered adequately prepared for retirement if it can maintain a similar real level of consumption as during its working years. Usually, 80% of pre-retirement income is considered adequate since the income needs of retirees are likely to be lower than those of workers (Aon, 2001). Households no longer need to save for retirement, taxes are lower, work related expenses disappear, the family size of retirees is smaller than that of workers, and households eventually pay off their debt (McGill et al., 1996). Second, retirement income adequacy may be defined as a constant nominal level of consumption during retirement as during working years. This means that consumption needs are expected to decline during retirement over time. Third, real consumption may decline if the marginal utility of consumption is held constant due to uncertainty about income and life expectancy (Engen et al., 1999). With uncertainty, households' marginal utility of certain present consumption is higher than the marginal utility of uncertain future consumption.

A number of studies have analyzed retirement savings adequacy, with differing results. For instance, Gustman and Steinmeier (1998) found that the average household could replace 60% of pre-retirement income in real terms, and 86% in nominal terms, leading the authors to conclude that households are adequately prepared for retirement. Further, Engen et al. (1999) found that 40-50% of households fell short of what they needed for adequate retirement income. The average replacement ratio for the median household calculated by Engen et al. (1999) is still 72%, leading the authors to conclude that households are close to being adequately prepared for retirement. Further, Haveman et al. (2003) found that retired beneficiaries had a median replacement ratio of about 80%, and that only 30% of households had a replacement ratio of less than 70% in 1982.

In comparison, several studies concluded that many households were inadequately prepared for retirement. For instance, Moore and Mitchell (2000) found that the median household would have to save an additional 16% annually of earnings if it were to retire at age 62 and an additional 7% annually for retirement at age 65 to finance an adequate real replacement ratio. Their estimate of a savings rate of 7.3% for households wishing to retire at age 65 was three times as much as what households actually saved (Moore and Mitchell, 2000). This meant that households had on average between 75% and 88% - depending on marital status - of what it needed when retiring at 65 in 1992 (Mitchell and Moore, 1998). Similarly, Bernheim (1997) calculated that on average baby boomer households were only saving at 34% of their target savings rate. Also, Gustman and Steinmeier's (1998) figures show that, based on real replacement ratios, the average household had 28% less than adequate retirement savings. And Wolff (2002a) concluded that 61% of households could not replace 75% of their pre-retirement income in retirement based on data from 1998, up from 56% of households in 1989.

But what does a savings shortfall mean? Often, shortfalls will still allow households to finance most of their expected consumption. Engen et al. (1999) point out that the households used in Mitchell and Moore (1998) could still finance more than 90% of the consumption prescribed by their model with no additional savings. Similarly, Haveman et al.'s (2003) study shows that about 20% of households have a replacement ratio between 70% and 80%. That is, one fifth of households have more than 90%, but less than 100%, of a typical 80% replacement ratio.

However, as wealth is unequally distributed, the shortfalls are larger for many households. Engen et al. (1999) calculated that households in the 75% percentile - the closest income group for households with average incomes - had 121% to 172% of what they needed for retirement. For the median household, the same ratios ranged from 47% to 124%. Thus, the median household reached only 62% of the preparedness of the average household in 1992. Moreover, the gap between average wealth and median wealth to income ratios increased further by 1998 (Wolff, 2002a). Following the unequal distribution of wealth, a large share of households is likely to experience retirement consumption shortfalls.¹ Gustman and Steinmeier (1998) found that households in the bottom quartile had nominal replacement ratios of 50% and real replacement rates of 33%, compared to nominal replacements of 121% and real replacement rates of 81% for the top quartile. Lastly, Haveman et al. (2003) found that single men were more likely to be inadequately prepared than single women, who were in turn less likely than married couples to be adequately prepared for retirement.

To make ends meet in retirement, when facing an income shortfall, households will have to curtail their retirement consumption. In fact, one of the distinguishing features between studies that conclude that households are adequately prepared for retirement and those that do not is the consumption pattern in retirement. For instance, Engen et al. (1999), Gustman and Steinmeier (1998), and Haveman et al. (2003) all assume that real retirement consumption declines with age.

A large minority of households are consistently found to be inadequately prepared for retirement. Little research exists to compare retirement income adequacy over time. Intertemporal comparisons, though, indicate that retirement income adequacy improved for the average household in the 1990s, but not for the median household (Weller, 2004a). Similarly, the share of households that could expect to replace more than half of their current income fell from 1989 to 1998 (Wolff, 2002a).

The number of studies indicating the many households are inadequately prepared for retirement can be explained in large measure by the failure of the existing pension system to adequately fund retirement savings. There are three reasons for the failure of the private pension system to make inroads in improving retirement income. First, for decades, the share of private sector workers covered by a pension plan has stagnated at

¹ Retirement savings shortfalls vary with demographics. Mitchell et al. (2000) and Engen et al. (1999) found that black and Hispanic married households experienced a larger shortfall than whites, and that less education resulted in a worsening of retirement income adequacy. Mitchell and Moore (1998) also found that single households were less adequately prepared than married ones.

about 46% (EBSA, 2002). Coverage is lower for minority workers than for whites (Purcell, 2003). Wolff (2002a) found that more than one-fourth of households between 47 and 64 had no pension benefits.

There are several explanations for this widespread lack of coverage. Many employers – especially small employers -- simply choose not to offer pension plans to their employees. Other employers offer a plan to only some of their employees. Further, some features of pension plans, such as vesting, age, and minimum tenure and hours worked requirements, can exclude workers from participating. Moreover, even if an employer offers a defined contribution (DC) plan to all employees, some employees may not contribute because they do not have sufficient discretionary income or otherwise choose not to contribute (Joulfaian and Richardson, 2001).² In addition, the tax incentives to contribute are modest or nonexistent for low and moderate-income households, but they can be substantial for higher income households.

Second, retirement wealth is unequally distributed. Kennickell et al. (2000) found that only 25% of families earning between \$10,000 and \$25,000 in 1998 had any retirement account from a current or past job, whereas 87% of households with incomes over \$100,000 did.³ Many households do not have enough income to save for retirement, even if they have the opportunity to do so. In 2000, the bottom 20% of households had incomes of less than \$25,000 (Mishel et al., 2002), but a working family typically requires more than \$35,000 per year to cover its basic needs (Bernstein et al., 2000), leaving little income to save. Ed Wolff (2002b) reports that the 40% of households with the lowest incomes had negative financial wealth, i.e., they owed more than they owned, in 1998. Further, there are larger tax incentives for higher income earners to save with a tax-advantaged plan, such as a 401(k), since contributions are not subject to income taxes until they are withdrawn. This is reflected in the share of tax subsidies accruing to high-income earners. For instance, Peter Orszag and Jonathan Orszag (2001) found “that two-thirds of the existing tax subsidies for retirement saving (including both private pensions and IRAs) accrue to the top 20% of the population.”

An important contributing factor to the differential accumulation by income is that smaller account balances tend to incur larger relative costs. Due to economies of scale, the administration of a large number of small accounts is greater than the administration of larger account balances. Consequently, costs for private sector investments tend to be greater for smaller account balances (Geneakoplos et al., 1998).

Further, in the current system, a worker whose employer does not offer a pension plan will have a difficult time accumulating sufficient retirement wealth to provide adequate retirement income. The tax-sheltered retirement savings device Congress created – the IRA -- has been most helpful to upper income savers, for the same reasons that DC plans have been most beneficial to high-income earners. Higher income earners have fewer income constraints and stronger tax incentives to contribute. Only 6% of all

² Low-income households save less than higher income ones (Lawrance, 1991; McCarthy, 1995).

³ Minorities have less adequate savings than whites and households with higher incomes and wealth raise their savings faster than others (Mitchell and Moore, 1998; Mitchell et al., 2000; Wolff, 2002a, 2002b).

workers eligible to contribute to an IRA actually contributed to one in 1996. Moreover, only 2% of tax payers earning less than \$25,000 in 1996 contributed to an IRA, whereas 22% of tax payers with incomes above \$75,000 contributed to an IRA (Smith, 2002).

Third, households are facing increasing risks with their retirement savings, mainly because of the growth of DC plans (Weller and Eisenbrey, 2002).⁴ For one, there are a number of financial market risks that are borne by employees under DC plans. One risk is the chance of misjudging the market and investing in a losing asset.

There is also the possibility that markets will stay down for long periods of time, generating low rates of return even for the savviest investor. Such market swings mean that two people of similar means who invest similar amounts can end up with vastly differing retirement savings. After 40 years of contributing to a hypothetical account invested solely in stocks, a worker retiring in 1966 could have replaced 100% of her career-high earnings, whereas a similar worker retiring in the late 1970s could have replaced only a little more than 40% (Burtless, 1998). Moreover, stock markets are driven to some degree by fads, such as the Internet bubble of the late 1990s, thus enticing investors to put too much money in one basket. Further, there is the risk that the information that investors rely on is manipulated as recent corporate scandals painfully illustrated. Misleading accounting statements attracted investors to presumably good investments that later turned out to be losing propositions. There is also the chance that violent swings in the market will lead people to save too little over the course of a lifetime. For instance, Gregory Mankiw and Stephen Zeldes (1991) found that savings by households that owned stocks were more volatile than consumption of households that did not, and that the volatility of savings varied with excess stock market returns. In other words, greater risks associated with retirement savings, reflected in more portfolio volatility, should result in fewer savings over the course of a worker's lifetime.

Another crucial risk associated with many private pension plans is longevity risk, i.e. households could outlive their savings. This risk is lower in defined benefit (DB) plans than in DC plans. But DB plan participants could face longevity risks if they choose a lump sum distribution option and do not annuitize their savings, whereas DC plan participants could reduce longevity risks by annuitizing their savings in the private insurance market.

III. Social Security's Role in Securing Retirement Income Security

As there are continued obstacles to substantially improving retirement income for many working families through the private pension system, especially at the low end of the income scale, Social Security plays a fairly important role. Its coverage is almost universal, its benefits are skewed towards lower lifetime earners, and its benefits are insulated from the vagaries of financial markets.

⁴ Additional risks include the risk that people cash-out of their retirement plans when they leave a job, thus reducing their life time accumulation, and the risk that households outlive their savings.

Over time, the coverage of Social Security has become almost universal. Wolff (2002a), for instance, reports that the share of households with Social Security wealth – the capitalized claim of future benefit streams – rose from 86.1% in 1983 to 97.7% in 1998. Legislative changes and increasing labor force participation rates contributed to this increase in Social Security's coverage.

Also, by its very structure, Social Security benefits tend to be skewed towards lower life time earners. According to SSA (2004a), a worker with low life time earnings, defined as 60% of average earnings, could replace 57% of his or her pre-retirement earnings with Social Security benefits in 2004. In comparison, a worker with average earnings could expect a replacement ratio of 43%, and a worker with high earnings, defined as 131% of average earnings, could expect a replacement ratio of 36% in 2004. These replacement rates, though, also show that, although Social Security's benefits are tilted towards lower income workers, they typically constitute a basic benefit as they fall far short of what is typically considered an adequate replacement ratio of 75-80% of pre-retirement income.

Similarly, Cohen et al. (2001) find that the expected internal rates of return under Social Security are higher for low income earners than for higher ones. Also, women, minorities and those with less than a college education can expect to have higher rates of return than their counterparts. That is, the combination of benefits that Social Security offers makes it a more attractive benefit for some groups than for others.⁵

The fact that Social Security offers a bare bones benefit is reiterated by the fact that the average benefit amounts are typically low. In 2002, Social Security paid out average retirement benefits of \$851.40 per month, average survivorship benefits of \$768.70 per month, and average disability benefits of \$696.00 each month (SSA, 2004b). Women typically receive fewer average benefits than men, and African-Americans receive fewer benefits than whites (SSA, 2004b).

Yet, despite low replacement ratios and average benefit amounts, Social Security plays a disproportionately large role as source of retirement income for those 65 and older. The average share of income originating from Social Security benefits for households 65 and older in 2000 was 58.0% (SSA, 2002). For households in the bottom 40% of the income distribution, Social Security benefits constituted on average about 80% of their income (SSA, 2002). Even the middle quintile still received the majority of its retirement income – 64% - from Social Security. And for all but the top 20% of income recipients 65 and older, Social Security was the single most important source of income. The fact that Social Security benefits constitute a larger share of income for households 65 and older than the average replacement ratios and low average monthly payments reflects the lack of private pension benefits for many households.

⁵ Although Social Security has a rather progressive benefit formula in comparison with other industrialized economies, its average benefit is comparatively low, often constituting only close to half the benefit of the average benefit of other industrialized economies, such as Italy or Germany (Weller, 2004b).

Lastly, the fact that Social Security benefits are guaranteed life time benefits that are annually adjusted with inflation makes them particularly valuable benefits for older retirees. For households between the ages of 62 and 64, Social Security constituted 27% of their income in 2000. But for households 65 to 74 years of age, the share of household income from Social Security was 52% and for households 75 and older it was 65% (SSA, 2002). Because many private pension benefits are not indexed to inflation, because important income sources, such as earnings, diminish in importance with age, and because households tend to draw down financial assets the longer they are retired, Social Security gains substantial importance with age.

IV. Social Security's Insurance Value

Although Social Security is typically associated with its importance for retirement benefits, it is crucial to keep in mind that Social Security offers benefits in addition to retirement benefits. In particular, Social Security offers benefits to the surviving family members of a deceased worker and to a worker and his or her family if the worker has become disabled. In 2002, Social Security paid \$281 billion in benefits to retirees, \$84 billion in benefits to the surviving family members of deceased workers, and \$66 billion in benefits to disabled workers and their family members (SSA, 2004b). That is, more than one third of Social Security benefit payments went to non-retired beneficiaries.

A large number of Social Security beneficiaries are children. Social Security paid benefits to 1.9 million surviving children of deceased workers and to 1.5 million children of disabled workers in 2002 (SSA, 2004b). The fact that in 2002, more than three million children received benefits from Social Security, including more than 100,000 students, shows the value of Social Security as an insurance benefit for working families.

These insurance benefits are similarly at stake, when Social Security benefits are reduced to account for the loss of payroll tax income under privatization (Diamond and Orszag, 2002).

V. Social Security's Long-term Financial Outlook

The perceived future need to change Social Security arises not so much from its levels of benefits, although changes may be occasionally warranted, but more so from the fact that Social Security's trustees predict a financial shortfall in the long-term future, unless changes to the system are implemented. According to the Social Security's 2004 Trustees Report (SSA, 2004a), it is anticipated that by 2042, Social Security will have exhausted its trust fund and that – without any changes to the system – tax revenues will cover more than two thirds of promised benefits. An immediate and permanent increase of the payroll tax by 1.89% would allow Social Security to pay all of its promised benefits for the 75-year projection horizon (SSA, 2004a).

Not only is the size of Social Security's anticipated shortfall manageable, it is also not going to increase in the long-term. Under Social Security's own projections, the share of GDP that will be dedicated to paying Social Security benefits will rise from currently

4.3% of GDP to 6.5% in 2034. After that, the share of GDP dedicated to Social Security will remain virtually unchanged. By 2080, the projected share of GDP going to pay for Social Security benefits will be 6.6%. That is, an average annual increase of 0.003 percentage points relative to GDP over a 36 year period (SSA, 2004a). In comparison, the federal government's spending on defense, without homeland security, increased from 3.8% of GDP at the end of 2000 to 4.7% in the first quarter of 2004. On an annualized basis, this is an increase that is almost five times faster than the expected increase from 2004 to 2034 - 0.09 percentage points compared to 0.02 percentage points (BEA, 2004). Put differently, the expected increase in Social Security expenditures is manageable within the parameters of the U.S. public finance system.

While Social Security's expenditures as share of the economy are expected to stabilize, payroll tax rates are not. The share of taxable payroll income that would need to be dedicated to paying promised Social Security benefits is expected to continuously rise from 11.0% in 2004⁶ to 17.5% in 2034 and to 19.4% in 2080 (SSA, 2004a).

The divergence between the economic costs of future Social Security payments and payroll tax rates suggests that part of Social Security's anticipated financing shortfall is not a result of economic factors, but of the particular design of Social Security. Specifically, the share of payroll that is taxable is expected to decline as is the expected share of payroll relative to GDP. The share of payroll that is subject to Social Security taxation will likely decline because a growing share of payroll income will fall beyond the income cap, above which income is no longer subject to Social Security taxes.⁷ And the share of payroll of GDP is expected to decline as a growing share of employee compensation is projected to come in the form of non-taxable benefits, such as private pensions or health insurance benefits. That is, Social Security will ultimately have to pay for a stable benefit stream, relative to the size of the economy, out of a shrinking tax base.

Social Security's expected financial shortfall can be addressed within the parameters of the system. Diamond and Orszag (2004), for example, combine several changes to the system to ensure its long-term financial balance. Those changes in particular are a continuous across-the-board benefit cut by indexing average benefits to longevity, increasing the cap for taxable income, such that only 10% of national income escape taxation, a reduced replacement ratio for high income earners, universal coverage through the inclusion of all newly hired state and local government employees, an additional payroll tax of 3% for all earnings above the income limit, and a continuous increase in the payroll tax (Diamond and Orszag, 2004). Additional examples of changes to Social Security's structure and their positive fiscal effects were included in the final report of the 1994-1996 Advisory Council on Social Security (SSA, 1997).

⁶ Social Security's cost rate in 2004 is below the combined tax rate of 12.4% since Social Security is currently generating a cash surplus.

⁷ In the past, this problem has been exacerbated by the fact that earnings inequality has risen as well, pushing even more aggregate income beyond the taxation limit (Diamond and Orszag, 2004).

VI. Privatization Too Risky and Too Costly

To address the projected long-term shortfall of Social Security's finances, a number of proposals have been made to replace part or even all of Social Security with individual accounts. For instance, President Bush's Commission to Strengthen Social Security (CSSS) called for a number of options to allow a voluntary diversion of part of the current Social Security payroll taxes into individual accounts. One of the options would allow workers to put 4 percentage points of their payroll taxes (up to an annual limit of \$1,000) into individual accounts (Diamond and Orszag, 2002). Another proposal recommends the diversion of an average of about 6.4% of payroll into individual accounts: 10% of the first \$10,000 dollars of wages and 5% of taxable payroll thereafter (Ferrara, 2003).

VI.1 Costs and Risks to the Individual

Such proposals pose a number of large and seemingly insurmountable hurdles to making them an efficient replacement of part or all of the current Social Security system. Two problems arise in particular. First, by replacing the current Social Security system with a system of individual accounts, an effective insurance mechanism is replaced with individual savings accounts. That is, the risks that are shared under the current insurance system are individualized. These risks can, at best, be mitigated by incurring often substantial costs in the private insurance market. Yet, a number of risks remain that cannot be eliminated.

While saving for retirement with individual accounts, investors face three important risks that can be mitigated, but not completely eliminated. For one, there is idiosyncratic risk, which can take two forms. Workers make their own investment decision, depending on their individual circumstances, which can result in above or below average rates of return. Workers also face their individual earnings histories that determine their ability to save. Another form of risk is the possibility that financial market rates of return remain below average for prolonged periods of time during somebody's working life. For instance, after 40 years of contributing to a hypothetical account invested solely in stocks, a worker retiring in 1966 could have replaced 100% of her career-high earnings, whereas a similar worker retiring in the late 1970s could have replaced only a little more than 40% (Burtless, 1998). And lastly, there is the chance that workers will outlive their retirement savings, so-called longevity risk.

The literature addressing the economic effects of the switch from DB plans to DC plans, shows two important lessons that apply to varying degrees to the privatization debate. First, the costs and risks of individual accounts are higher than those of defined contribution, pooled plans. In individual accounts, the workers bear all the risks and responsibilities. Importantly, there is no guarantee of future benefits. Most notably, assets are no longer pooled and workers can no longer take advantage of economies of scale to the same degree that Social Security can. In addition, employees lose the potential of a guaranteed benefit and thus incur more uncertainty with respect to their expected retirement benefits.

Because workers are less likely to take advantage of economies of scale, their administrative costs rise on average, and even more so for smaller account balances or participants in small plans. At the low end, the Congressional Budget Office (CBO, 2004) estimated the costs for existing DC plans to amount to an average of 0.8% of assets for large plans, and fees for smaller plans of about 1% of assets annually. Assuming annual contributions of 2% of earnings, total account balances would be reduced by 21% over an entire working life for large plans and by 30% under small plans. These costs, though, may understate the administrative costs of a privatized system of individual accounts, where economies of scales would likely be reduced further. Already, the administrative costs of mutual funds are substantially larger than those of existing DC plans. CBO (2004) reports average annual administrative costs of 1.28% for equity mutual funds.

With individual accounts, savers also face implicit cost increases as the uncertainty of their retirement savings has grown. To reduce the financial market risks associated with individual accounts, savers could purchase insurance. Specifically, workers could purchase lifetime annuities upon retirement to minimize longevity risks, and they could purchase minimum investment guarantees for their portfolios during their working careers to reduce market risks. The costs of a lifetime annuity amount to an average of about 5% of total accumulated savings, with smaller account balances accruing larger costs (Poterba and Warshawsky, 2000). To see what this means in terms of lifetime benefits, consider that for a person retiring at 65 with an average life expectancy, private annuities are about 15 to 20% less than they would be without the costs of purchasing the insurance (CBO, 2004, 1998; Poterba and Warshawsky, 2000; Geneakoplos et al., 1998). And the costs of guaranteed minimum benefits are also non-trivial. For instance, to guarantee the rate of return on bonds with a balanced portfolio (50% stocks and 50% bonds) over a 40-year investment horizon, investors would have to spend 16.1% of their contributions to their retirement account on the guarantee (Lachance and Mitchell, 2002).

Individual accounts incur another risk that workers can typically not insure against, but that Social Security offers some measure of protection against. Specifically, because workers usually get labor income – the primary source for savings – from just one employer, they are not diversified on their income side and consequently vulnerable to large fluctuations in income arising, for instance, from lay-offs, reduced overtime, and the employer's bankruptcy. But shocks to labor income are not randomly distributed. Some groups of workers are more likely than others to have a more tenuous attachment to the labor market. For instance, women, minorities, those with less education, among others, have higher unemployment rates, longer spells of unemployment, and greater variability in earnings than their counterparts. These groups, thus, face systematically greater labor market risks than their counterparts.

Not only do shocks to labor income vary systematically by demographic groups, they are also systematically related to the business cycle and thus to financial returns. Employment and wage growth are higher during an economic expansion than during a contraction. In fact, both systematic variations are linked, such that the labor income of

those groups with a more tenuous attachment to the labor market see their labor income vary more with the business cycle than the labor incomes of their counter parts. As labor income fluctuates with the business cycle, so do savings. Put differently, some groups are more likely than others to see their labor income decline during bad economic times, when financial returns tend to be low and opportunities for dollar cost averaging are high. Consequently, their total accumulations per dollar invested should be lower than those of their counterparts, imposing an additional cost of individual accounts for some workers.

In research that I am conducting with Professor Jeff Wenger of the University of Georgia, we found that the size effect of the interaction between labor income shocks and the stock market can generate some degree of variance in account balances. In particular, women tend to see substantially lower real accumulations per dollar invested than men. Also, African-Americans experienced somewhat smaller account accumulations per dollar invested over the period from 1979 to 2002 than whites (Weller and Wenger, 2004).

Since labor income cannot be diversified, households have limited means to insulate themselves from this labor market risk with individual accounts. In comparison, the calculation of Social Security's benefits does not expose workers to this risk. For one, there is no direct connection between Social Security contributions and financial market performances. Second, because Social Security calculates an average wage for a worker's entire career as part of its benefit calculation and then replaces lower lifetime averages with a higher relative benefit, workers who are more likely to experience adverse labor income shocks are partially compensated for these shocks.

Second, the economic assumptions underlying the Social Security forecasts, which are often used to justify privatization, are inconsistent with the assumed rates of return that many advocates of individual accounts make. Baker (1999, 1997) points out that the Social Security's trustees assumptions of well below average wage and productivity growth imply economic growth that will also fall below long-term historic averages. Yet, over the long run, stock market returns closely mirror the pattern of economic growth. If stock market rates of return diverged substantially and for a prolonged period of time from this pattern, it would imply that an ever increasing share of national income would have to be accrued in the form of profits to avoid unrealistically high stock market valuations. However, logically this would imply that an ever shrinking share of national income would be paid in the form of wages. Baker (1997) demonstrates that the labor share of national income can quickly approach unrealistically low levels. More realistic and more consistent with the overall economic assumptions of the Social Security trustees report would be real rates of return that are below their historical averages. Consequently, the account balances that could realistically be expected would be substantially lower than is often forecast by those favoring the replacement of Social Security with individual accounts (Baker, 2001). In other words, beneficiaries are less likely than is typically argued to replace reduced Social Security benefits with higher earnings on their individual accounts.

VI.2 The Macro Economic Costs of Privatization

Third, despite claims to the contrary, these proposals typically do not improve the financial outlook for Social Security in the long-run, unless they cut benefits substantially. In principle, replacing part of Social Security with individual accounts means that Social Security receives less income to pay for promised benefits. To fill this growing gap, Social Security would either have to receive large transfers from general revenue, raise payroll taxes, or cut benefits. In the two examples mentioned above, the solutions appear to be transfers from general revenues and reduced benefits, although the options are often not clearly detailed. Specifically, it is often unclear how the increased transfer from general revenue would be financed, i.e. which taxes would grow.

To fully understand the macro economic costs of individual accounts, two factors need to be considered. First, the rise in costs associated with individual accounts is not offset by an increasing in personal savings. Again, research on the shift from DB to DC plans sheds some light on this issue. For one, Papke (1999) concluded that many new 401(k) plans replaced existing DB plans and did not increase net personal savings. Similarly, Engen and Gale (2000) found that savings incentives, such as 401(k) plans, tend to raise wealth for low-income households, but that they have little effect on average savings rates. That is, there is evidence of large substitution effect from traditional DB plans to newer DC plans, but little evidence that the higher cost savings vehicles have substantially raised retirement wealth.

The discussion over the effects of Social Security on savings also sheds an interesting light on the question of whether Social Security privatization would result in more savings. The original debate rested on two propositions regarding the link between Social Security benefits and other savings. First, Feldstein (1974, 1976, 1977) argued that mandatory savings through Social Security resulted in more consumption and fewer savings based on an extended life-cycle model. Barro (1974, 1976, 1978) argued that neither workers nor retirees will alter their consumption, and thus their savings behavior. Instead, beneficiaries will directly or indirectly transfer e.g., in the form of inheritances, to the generations that will have to pay for higher benefits through their payroll taxes. Consequently, lower Social Security benefits should not result in more savings.

Empirical studies have found only small effects of Social Security on savings. Munnell (1974) found that the two countervailing effects of Social Security on savings offset each other, and that there is no substitution between Social Security and savings. In contrast, Feldstein (1996) found that an additional dollar of Social Security wealth translated into a reduction of private savings by 2-3%.

Feldstein's (1974; 1996) results on the substitution effect of changes in Social Security benefits on private savings have been questioned, though. Meguire (1998) found that correcting for wealth mismeasurement and for structural breaks the effect of Social Security on savings is reduced by more than 90%. Also, Coates and Humphreys (1999) found that the findings are sensitive to model specifications and that the average impact of Social Security on savings is likely to be smaller than originally estimated. Wolff

(1988) found no substitution effect, and Bernheim and Levin (1989) found no relationship between Social Security and private savings for couples. Thus, the link between public retirement benefits and savings is weak at best, suggesting that households will only replace a small share of a benefit cut with private savings.

Second, the costs to general revenue from replacing part of Social Security with individual accounts could be substantial. For instance, Diamond and Orszag (2001) estimate that the option to divert 4 percentage points of the payroll tax into individual accounts that the Commission to Strengthen Social Security proposed would amount to a financing shortfall in 2001 net present value terms of \$2.2 trillion dollars. If disability benefits, which would be reduced from current law levels under this proposal, were maintained, the shortfall would amount to \$2.8 trillion in net present value terms. As Diamond and Orszag (2001) point out, that “although the Trust Fund would be “made whole” by the assumed infusion of very large sums of revenue, the Commission Report does not explain where the transferred funds would come from.”⁸

A similar criticism applies to Ferrara’s (2003) proposal. In particular, the expectation here is that greater revenues would be generated from higher capital income that results from more investment financed out of more stock investments. Thus, theoretically the government could pay for current transition costs through higher capital tax revenues in the future.

Leaving practicality issues aside, this argument suffers from the economic shortcoming that the empirical evidence suggests at best a weak link between the stock market and productive investment. For one, as discussed above, there is little evidence that tax advantaged savings have actually increased national savings. It seems reasonable to assume that Social Security privatization would likely be offset by reduced savings elsewhere with, at best, an ambiguous effect on national savings. Also, the 1990s probably serve as the best example against this argument. From 1994 forward, the U.S. corporate sector in the aggregate repurchased more shares than it issued. Put differently, the stock market was a net drain on corporate resources, not a supply of new funds (BoG, 2004). However, despite this qualitative change in the stock market, investment accelerated in the late 1990s (BEA, 2004). But without the link between stock market investment and productive investment, this financing scheme loses its foundation.

In addition to large transfers from general revenue to Social Security that would be required under the Commission’s proposed option, benefits would have to be cut. Diamond and Orszag (2002) estimate that Social Security benefits would be reduced by 41% compared to the benefits scheduled under current law for a worker born in 2002 and retiring in 2066. Similarly, disability benefits would be gradually reduced under this proposal. For a worker starting to receive disability benefits in 2050, benefits would be 19% lower compared to the current benefit schedule (Diamond and Orszag, 2002).

⁸ It should also be noted that, if the source of these general revenue funds are not disclosed, the progressivity of the proposal to privatize Social Security cannot be evaluated.

VII. Conclusion

Improving retirement income adequacy poses a serious challenge to public policy in the US. Specifically, many workers are lacking pension coverage. Retirement wealth is unequally distributed, and the risks of retirement savings have grown with the shift from traditional defined benefit to defined contribution pension plans. In recent decades, the problems have likely grown worse than better.

In light of the obstacles to improving retirement income security through the private pension sector, the relative importance of Social Security has grown. It offers a universal, progressive, guaranteed, yet basic benefit.

Moreover, Social Security's finances are secure for the foreseeable future and the anticipated financial shortfalls are limited both in their size and in their timing. After an adjustment period of three decades, Social Security's expenditures are expected to stabilize relative to GDP. This problem can be addressed within the parameters of the existing structure, i.e. without radically altering its character by privatizing it.

Yet, a number of proposals have been made to significantly alter the face of Social Security. In particular, these proposals envision replacing part of Social Security with a system of individual accounts. Such a system, though, carries unjustifiably large risks and costs to the individual and to the economy as a whole. Importantly, individuals would only be able to partially protect themselves from the greater risks associated with individual accounts, and only by incurring substantial costs. At the same time, though, tax payers would likely face rising costs to pay for the transition from the old Social Security system to a new system of individual accounts. Moreover, while taxes would likely have to rise to pay for this transition, the proposals also advocate the reduction of Social Security benefits relative to the benefits scheduled under current law.

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The CHAIRMAN. Christian, thank you for very much for those comments.

Let me ask some general questions of all of you and then some specific ones. You have all heard Mr. Walker talk about the GAO study. What, in your opinion, is the most interesting or profound finding in that study?

Peter.

Mr. FERRARA. Well, I think it is actually a very fascinating study because the conclusions I draw from that is that if their projected scenario is correct, it reduces the transition costs to large personal accounts because the gap that has to be covered is smaller. It also means that personal accounts are more urgent because the implication of their analysis is that the rates of return are lower under Social Security than we have expected so far. So it is an even worse deal now today for current workers than we had expected, and so it increases the urgency of large accounts, and it also shows that because the long-term deficit is smaller, what I have been saying all along is that with large accounts, you don't need any other reductions in Social Security benefits. You don't need price indexing, which is a very large reduction in the future promised benefits, and because the large accounts shift so much of the burden to the accounts and away from Social Security, they eliminate the long-term deficit by itself. That is what the chief actuary's score showed.

Now, the CBO analysis bears me out in this, that you do not need price indexing if you go to the larger accounts. You don't need any reductions in future Social Security benefits to close the gap, because if you go to the large accounts, it eliminates the gap by itself, because again, so much of the burden of paying for retirement benefits is shifted to the account. When you go to larger accounts, they take more of the burden.

The CHAIRMAN. You were speaking mostly of the CBO.

Mr. FERRARA. Right, the CBO.

The CHAIRMAN. What about the GAO?

Mr. FERRARA. Oh, I am sorry. I mean, I think the GAO analysis doesn't really deal that much with my proposal. I think that they are accurate in what they say in laying out the parameters, that they show that, for example, adequacy and equity are two goals, but I think what is interesting there and the most interesting implication I draw out of that is with a large account proposal, those two goals are not in conflict. Those two goals are both increasingly satisfied, improved with the larger account. Benefit adequacy is improved. The current system does not provide benefit adequacy. The benefits are inadequate in the current system.

So if you go to the large accounts, you have much bigger increases in future benefits, and you have—so it scores on the adequacy side, and you have much bigger increases in future returns because you can take more advantage of the higher returns in the private market. In this analysis, we have got to take into account the degree to which different proposals enhance future economic growth and productivity. What is missing in a lot of the analysis is that when you have large accounts or you have so much savings and investment being produced into those accounts, those contribute greatly to future economic growth. Again, this is based on decades of research from Professor Martin Feldstein at Harvard

and others who have written about it, the CATO Institute, Heritage Foundation and others, and so to use words like a “free lunch”, you are ignoring people who use those. You are ignoring the economic growth impacts of such a productive increase in savings and investment, and all of that becomes bigger, much bigger, when you go to the much bigger accounts.

So they point out these two goals sometimes are in conflict. Here, they are both served by the larger accounts, both adequacy and equity.

The CHAIRMAN. Jeff.

Mr. BROWN. Well, I would first begin by actually commending the GAO on what I think is, methodologically a very well done report. The study shows that, as we have learned in the academic literature over the last several years, that an accurate measure of progressivity requires that one take into account the complex household and family interactions. I think the most important finding, and one of the points I made in my testimony, is that in any reform, whether it includes personal accounts or not, it is possible through careful construction of the policy to make the system as progressive or as regressive as one wants.

It is sometimes assumed incorrectly that by moving to personal accounts, that one necessarily is going to do something to hurt the poor, and I think the GAO proves this assertion to be false. In fact, it is quite possible to design a personal account system that is very good for low-income families.

The CHAIRMAN. Thank you.

Jeff.

Mr. LEMIEUX. Thank you. I have a similar reaction. Both CBO’s work and GAO’s work are leading toward a higher level of analysis for all of these proposals. For example, until now, we haven’t really seen from official Congressional or Administration sources lots of publications on the progressivity of the different plans. I included in our packet some tables that show, for example, that the Graham plan does seem to increase progressivity fairly substantially, but these are based on data that I have cobbled together from a variety of sources, some of them unpublished. With the CBO and GAO reports, I think we will have more authoritative work on how account proposals of varying sizes would affect the progressivity.

The CHAIRMAN. Right.

Christian.

Dr. WELLER. I agree. I have the utmost respect for my colleagues at GAO. I think this is a study that moves at least some of the issues in the right direction, but I think a lot of the debate that we are having is actually not analyzed, and I hope that this is the first step in the right direction. In particular, the study only looks at progressivity and makes a lot of qualifying remarks and in particular on the average level of benefits, but also on the financing of the transition costs to approach the individual account system. I would also submit that I think the study is discounting somewhat the risks associated with the individual accounts just by using hypothetical examples rather than the full heterogeneity of the real word, and I hope that this study is going in the right direction in terms of analyzing the complexity of all these reform proposals and the costs associated with these reform proposals.

The CHAIRMAN. Yes. Thank you.

Before I go to you all individually, Jeff, you had mentioned in your analysis in the different plans the need for bipartisanship on this issue and the lack, at least to date, in the debate that has gone on. Let me only suggest that this is called warm-up rhetoric, that in the end, any reform of the Social Security system by its very character will be bipartisan. I just believe that firmly and I say that because of the character of this institution and the inability to move anything that isn't. We just have laid to rest a President who recognized the need to become very partisan on the issue of Social Security reform back in the early eighties. I happened to be there and watched he and another Irishman duke it out until they realized they weren't going to get anywhere and they need to reform system until they work collectively together, and they ultimately did, and I think that that refrain certainly stays with me, and I think it stays with most who recognize that what we are trying to do is build a base of information from which all of us can look, hopefully, with limited partisan or philosophical bias, look objectively at a system that is critically necessary for the American people in the long term and do it right so that we can all benefit.

Mr. LEMIEUX. I hope we can achieve that level of bipartisanship before we come to a crisis like we did in the 1980's.

The CHAIRMAN. My guess is there will be a few dust-ups before we get there.

Peter, let me go back to you with a question. How do you respond to the critics of personal retirement account proposals who argue that they promise reasonably higher returns and realistic revenue feedback?

Mr. FERRARA. Well, the returns that we used are the historical, standard historical, market returns. They are returns going back a hundred years. They are very similar to what the chief actuary uses in his estimates, and most analysts use the same returns. I mean, the most authoritative source is Ibbotson Associates, where they combine stocks and bonds and Federal debt and inflation and report the returns going back dozens of years, debt going back several decades, and you can use other data and go back 200 years if you want. The returns are basically the same.

Well grounded in the economic literature, I think an important fact that people overlook is revealed in the work of Martin Feldstein, because the important number here is not really the bond returns and not really the stock returns, but the before tax real rate of return to capital. If you are shifting from a pay-as-you-go system like we have today with Social Security, which is just redistribution and not investment, and you shift to a system that is real savings and investment, the net gain from that is not the corporate bond return and it is not the stock market return. It is the before tax real rate of return to capital, and that is just overlooked by too many people.

Now, that is where you get the corporate revenue feedback, because you see when the accounts buy these stocks and bonds, what happens to the money they use to buy them? That goes to the corporation selling the stocks and bonds. Corporations use that money to make investments, build new plant equipment, start new businesses, hire more workers, and they earn money back on that. That

money that is earned at the corporate level is taxed, and that provides the revenue feedback.

Now, you know, Martin Feldstein, Chairman of the National Bureau of Economic Research, is one of the chief progenitors of this idea going back to the 1970's, where I learned about it when I was a student of his at Harvard, and it is well grounded in the economic literature. Moreover, the literature shows that, you know, extensive writings over the years, that this shift to a large personal account system is going to have a very substantial economic growth effects, not just on terms of the corporate revenue feedback, but you have got increased savings and investment. You have got a more efficient labor market. You have got reduced taxes. So the total economic growth effects are going to be much larger than was taken into account in the chief actuary's score when he included the corporate revenue feedback. So that is only a small part.

If you did a comprehensive analysis of the full economic growth effects and the rate of revenue feedback that would result, the revenue feedback would be much greater than you had there, and you can't take—when you go to the larger accounts, you are taking basically 20 percent of the Federal budget and now that is going into a savings and investment system. That is a big change, and you can't discount the economic effects of that, because the economic effects are going to be huge.

So these are, in fact, very moderate assumptions that are used in here. The true reality is going to be, in fact, much greater.

The CHAIRMAN. Well, I happen to agree with you in general.

Mr. FERRARA. Thank you.

The CHAIRMAN. I think that is a very exciting prospect long term for our country if we can move in that direction.

Jeff Brown, in your view, when the President's Commission considered funding the transition to a system of personal retirement accounts, were they talking about new transition costs required by reform or costs that already exist?

Mr. BROWN. That is very good question, because I think the transition cost concept is often misunderstood. These are not really new costs in a present value sense. What we are really talking about here is a re-timing of costs. The transition costs will rise because of the fact that we have made benefit promises to current workers and retirees, and if we fulfill those promises and simultaneously want to fund the accounts, that certainly requires that we put more money aside today in order to do that.

Another name for putting more money aside today in order to reduce the burden on future generations is saving. What these transition costs, if you want to call them that, are simply way for us to increase our national saving. So I actually do think it is appropriate to refer to these as an investment, because while it does require that we as a Nation reduce our consumption today, it has the benefit of either reducing tax burdens in the future or allowing a higher level of benefits and consumption in the future.

The CHAIRMAN. One of the issues raised by critics of personal retirement accounts is that of market risk. What dimensions should we consider when we think of risk in that, Jeff?

Mr. BROWN. Sure. Well, I am a finance professor, and so I certainly recognize that the ability to access higher expected returns

in equity markets does entail an increase in financial market risk. However, there are a couple of additional points that are worth noting. First, people who make that argument often assume that there is no risk to the current defined benefit system, and I think that is incorrect when we are facing a significantly underfunded system. There is political risk to the current system, that benefits and taxes can be changed going forward, and having a mixed system like was proposed in Model 2 actually allows allowing some diversification of political and financial market risk.

Second that in Model 2 of the Commission, the accounts were voluntary, and even if you chose the account, there was no requirement that you invest in equities. You could actually come out ahead with a very conservative investment portfolio if you wanted to. So there are mechanisms in place for managing that risk which does exist.

Mr. FERRARA. May I make a couple of points in answer to that question?

The CHAIRMAN. Let me proceed, and then I will let you all do a wrap-up response to any other comments that individuals, that you as panelists, have made, because we will run out of time, Peter, if we don't move through.

I want to get to you, Jeff Lemieux. Your testimony is supportive of personal accounts; however, you do have concerns with plans that promise, quote, a free lunch. Could you elaborate on the features most associated with what you call a free lunch?

Mr. LEMIEUX. Yes. I think that it boils down to whether or not you are going to make an attempt to pay for the transition costs of moving to accounts, whether they are medium-sized accounts, small accounts, or large accounts. As Jeff was talking about just a second ago, it is really a matter of timing and a matter of saving. If we sacrifice now, then we will have a better funded system, but implicit in sacrifice is paying for the accounts, perhaps, with revenue increases or spending cuts or other things. If we don't pay for at least a significant share of the transition costs, then we won't really be increasing national savings. It will be neutral. We will be putting money in people's accounts, but we would be taking away from the public account. I think the financial markets would view that as roughly neutral, and if that were the case, then you wouldn't have any of these potentials for the sorts of economic improvements that Peter has talked about. So my main worry about the free lunch is that we haven't figured out how to pay for at least a substantial share of the transition costs in any accounts.

The CHAIRMAN. I think that puts that in context from how you see it.

As a former CBO analyst, you are probably familiar with CBO's new projections for Social Security or the Social Security system. Are there any real changes in CBO's projections compared to the actuaries?

Mr. LEMIEUX. I don't think we have had a chance to really analyze it deeply, but I did a superficial graphic here in the testimony that shows the trends in costs and revenues, and they look to me to be substantially similar, certainly within the bounds of any sort of reasonable difference of opinion on a wide variety of issues. I don't think it changes the story at all. We have a demographic and

political problem ahead of us with Social Security. It is substantial. It is not as big as Medicare or perhaps interest, on the national debt but is substantial and we should address it.

The CHAIRMAN. OK. Thank you.

Christian, your testimony is critical of personal retirement accounts, yet doesn't really talk about an alternative. Do you have any specific ideas of how to address the challenge that is obvious with the Social Security system?

Dr. WELLER. I would submit that there is a number of proposals out there. We don't have, the Center for American Progress doesn't have its own plan. I personally don't have an individual plan, but I think there are enough options out there. I think one idea that is worth debating is the Orszag-Diamond plan. The alternative is to go back to the 94-96 Advisory Council on Social Security, and there are a number of options that we could address within the system.

I would lean probably in the direction away from cutting benefits, because I think that the overall benefit structure is a bare bones system.

The CHAIRMAN. Yes. Well, in the Diamond-Orszag plan, their plan raises taxes on workers and cuts benefits for them in their retirement. It is this approach. What redistribution features of their plan do you find most attractive or least attractive?

Dr. WELLER. I find least attractive the idea of indexing benefits, benefits cuts to longevity. I think that we will ultimately see an erosion of retirement income adequacy for low-income workers. I think the literature is very clear on that, that we won't see an adequate commensurate increase in private saving to compensate for that. I think the idea of raising taxes beyond the taxable limit at this point is an attractive feature.

The CHAIRMAN. OK. Now let me turn to all of you, and I will start back with you, Peter. You can choose in this last round to critique or debate what one other of your panelists have said or make a point that you don't feel has been made for the record.

Mr. FERRARA. Well, let me address two issues. One is the risk issue. I want to emphasize that in the plan that I have put forth, there is Federal guarantee that all workers with personal accounts would get at least the benefits promised under current law. So in that sense, the risk issue is enormously mitigated, if not eliminated completely, for workers across the board. This is a flat-out Federal guarantee.

Now, a second critical part of this risk issue and the reason that guarantee works is because the gulf between market investment returns and the returns Social Security promises is so large, and that is just overlooked in the risk analysis. There is virtually no probability that over an entire lifetime, the returns in the markets are going to fall below what Social Security promises today. In order for that to happen, the returns in the stock market over the last 75 years would have to fall by 80 percent and stay that low for the next 75 years, and that would just give you the return promised by Social Security. If that happens, America is going to be a very different and far, far less prosperous country than it is today. It would be a Third World nation rather than the prosperous nation we know. So with that very large gulf, first of all, that miti-

gates the risk enormously. Second, it means that you can offer a guarantee like that, and the chief actuary in his score scored the cost of the guarantee using the standard Federal Government's methodologies for guarantees, and the cost was very small because that gulf is so large.

Now, on the second issue, the transition issue, the free-lunch issue, people who make this point want to count only tax increases or cuts in future Social Security benefits as counting in financing the transition, and that is just too narrow. I think that what my plan shows and what the chief actuary's score shows is you don't need tax increases and you don't need cuts in future benefits if you go to large accounts. One of the huge implications of large accounts which is not fully appreciated, and what I was trying to show through the chief actuary score, is how quickly they shift benefits and how massively they shift benefits to those personal accounts.

So why argue about what Social Security benefits are going to be in 2050 and argue that we should be cutting them when if you go to a large account, people will be actually getting better benefits than Social Security even promises from the personal accounts. So it is a meaningless argument to argue about we need to cut benefits in 2050 when, in fact, if you go to the large accounts, that is not even an issue.

The plan I proposed provides for full and complete financing of the transition through reduced personal consumption in two ways. One is the reduction in growth of Federal spending, which reduces present consumption, and the second is devoting part of the increased growth to savings rather than consumption. In conclusion—

The CHAIRMAN. My time is going to have to ask you to stop at that point.

Mr. FERRARA. That is fine.

The CHAIRMAN. Thank you very much. I find your ideas very exciting, because I look at the opportunity spread across a long period of time, and I can't imagine—and yet I know we are going to be faced with the reality if we take the current model and simply tinker with it, we are going to try to have to look out into the future and project benefits in 2050, and I find that a rather impossible task for this mind to come up with.

Jeff.

Mr. BROWN. I would just like to respond to two points, one made by each end of the table. The first is that financial economists and actuaries actually think very differently about the true economic cost of guarantees. As a financial economists I would agree that guaranteeing benefits equal to current law scheduled benefits is actually extremely expensive, much more so than the actuaries analysis would suggest.

The second point I would make is about plans which would not make any benefit reductions whatsoever, such as the type that Mr. Weller was referring to. It is really important that one not just look at adequacy of benefits without thinking about the lifetime tax burden that such a plan is going to impose on families. It is a simple mathematical fact that the only way that we could guarantee to pay current law scheduled benefits without personal accounts is through fairly enormous payroll taxes or other tax increases on

current and future generations, and I think that that has a strong redistributive effect as well.

The final point I would like to reiterate once again is that it is actually quite possible to design a personal accounts reform that over the long run allows the system to be sustainable, but with careful design provide some very strong protections for low-income individuals.

The CHAIRMAN. Jeff.

Mr. LEMIEUX. I would just like to emphasize the four criteria for evaluating reform plans: first, the impact on the budget; second, the degree of progressivity. Ultimately, we would like Government to be small and progressive, and Social Security is no different; third, the opportunities for wealth creation and the use of Social Security as a lever to help low-income people save and accumulate assets; and then, fourth, the presence or absence of gimmicks. I think it would be sort of a false promise if we tell the next generation, Look, we are going to provide you with an attractive new account, and, Oh, by the way, we are also going to provide you with an awful lot more of the National debt which you ultimately have to pay off in one way or another.

Then the final comment is this hyper-politicalization of Social Security has become a problem. Even the most bland or technical analysis can sometimes be used for partisan political propaganda or other, you know, ways if it is not spelled out very clearly what the analysis means, and I am really encouraged by the GAO work and the CBO work and always the great professional work by the Social Security actuaries to just try and spell it out very clearly so that your data isn't used in the wrong way and it eventually helps the debate.

The CHAIRMAN. Christian.

Dr. WELLER. I would like to come back to the point that individual accounts carry risks with them. I think that some risks are understudied, in particular the labor market risks that I mentioned here. I think that we need to pay more attention to that. In that same vein, I was struck a little bit by what Jeff Brown said earlier, and I think we can probably find some common ground here. If we care and are concerned about savings, National savings, which I am as a macro economist, but also personal savings, I think we should have a debate over what is progressive savings and what are progressive savings policies, but I think that debate should happen outside of the parameters of Social Security.

Social Security is an insurance mechanism, not a savings mechanism. Let us leave it at that. Let us talk about progressive savings initiatives instead.

The CHAIRMAN. OK. Let me conclude with this brief comment: I have been fascinated in the debate over Social Security since I came to Congress 24 years ago, and I watched the politics of it then and I have watched the politics of it now. I guess the analysis that I can use, because I held a lot of hearings out in my State and around the country, talking about Social Security, talking about all aspects of it, is to watch the generational differences at work out there now. They are very, very significant, and I don't think we can overlook those, Jeff, as your concern relates to the partisans or the politics of Social Security.

Having gone through the debates of the eighties on Social Security reform, I would call that the old politics. I think somebody not long ago mentioned the old Europe versus the new Europe. I would suggest that with the tools we have today and the understanding we have today and the youth and their frustration about putting such large sums of money into something that will return so little or comparatively speaking, that the new politics of today, making a single assumption that is critical is that those who are currently on or about to go on are held relatively whole or whole is going to be a much different debate than we have ever had before on Social Security and that the political transition this country is going through as it relates to these kinds of analysis and understanding are going to be considerably different.

There is a sense of independence out there because of just the character of the work force today and the tools that are available to it for investment and analyzing its own economic concerns that I find at least I am much more excited about the idea of a constructive debate on a system that is allowed to alter itself into a new form, if you will, over a generation of time as being something that really is going to be an exciting thing to put this country through, because I have a feeling that the country will engage in it very aggressively, at least I hope they will.

That is part of why we are here and part of why we are laying this informational base, so that as we move the Congress toward this issue in the next few years, we will have well established some of the parameters, I hope, for the debate and the realities of where we might be able to get with the kind of reform that is going to have to be anticipated.

Gentlemen, thank you all very much for your time before the Committee and your effort. I appreciate it.

The Committee will stand adjourned.

[Whereupon, at 11:50 a.m., the Committee was adjourned.]

